FINANCE AND INVESTMENT

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THE CAPITALIZATION OF A BUSINESS CORPORATION
DISTRIBUTION OF EARNINGS
CONSOLIDATION OF CORPORATIONS

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FINANCE AND INVESTMENT
(PART 3)

THE CAPITALIZATION OF A BUSINESS CORPORATION

AMOUNT AND TYPE OF SECURITIES

1. Definition of Capitalization.—The term capitalization, as heretofore noted, means the total par value of all the securities issued by a corporation and outstanding at any given time, such as stocks, bonds, and notes. Stock issues are usually the most important element in the capitalization of a corporation. A corporation may obtain the permission of the state to issue a large amount of capital stock, but only issue a small part of this at the time of beginning business. If, for example a corporation has capital stock of $1,000,000 authorized in its charter, and begins business with only $100,000 of this authorized capital stock issued, reserving the remaining $900,000 of authorized capital for later issue, then the capitalization of the corporation at that time will be $100,000.

2. Basis of Capitalization.—When the incorporators decide to apply for the charter, they must estimate the amount of capital which they will need not merely to begin operation and to develop the enterprise, but also the amount that will provide for later capital requirements, after the business has become a going concern.

In estimating the amount of capital necessary to establish an industry, it frequently happens that the financial plan does

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not provide for the proper amount of working capital to take care of the purchase of raw materials and supplies, for paying labor costs, for producing finished articles, and for selling their products while waiting for payments to be made. If their estimate of capital requirements does not include a fair margin for these purposes, a new business may very soon find itself in financial difficulties.

It is, therefore, very important that the manager of a new enterprise should provide fully in his financial plan for all the requirements. Every new company is more or less of an experiment. It requires time to find the men best fitted for different positions. Months may pass before the methods of operation are simplified and standardized so that there will be relatively little waste in production. Time is required to develop the different advertising and selling programs to attract customers. In other words, every new business must go through a period of trial and error, and this experimentation is usually very costly. If the venture is sound, this initial cost will be earned later on, when the business has become established; but unless the financial plan makes full provision for this high cost at the beginning, the business, though intrinsically sound, may be doomed to failure before it has gotten a fair start.

3. Reduction of Capital Stock.—If a company eventually finds that, owing to an overestimation of future earning power, it has outstanding an amount of stock so great that it is improbable that its earnings will ever reach a point where dividends can be safely paid, and especially when it finds that there has been such an accumulation of unpaid dividends on preferred stock as to make payment of dividends on common stock highly impracticable, the question arises as to the advisability of reducing the capital stock to a dividend-paying basis and of the means to be used to do this. When, because of a great improbability that the stock ever will be on a dividend-paying basis, the value of the stock has fallen, or never risen above a nominal figure, it is essential that the amount of capital stock outstanding should be reduced.

A company, for example, with $500,000 of surplus earnings applicable to dividends cannot, as a rule, safely pay out more than $300,000. If $250,000 of this $300,000 is required to pay preferred dividends, and if the amount of common stock is $10,000,000, the $50,000 remaining equals only one-half of one per cent. on the total common stock. There may also be accumulated dividends on the preferred stock, making the payment of dividends on the common stock even more improbable. Common stock, under these circumstances, will usually sell for a nominal figure, under $5 per share, and very little of it can be sold at any price. If, however, the $10,000,000 of common stock could be reduced to $1,000,000, and the accumulated dividends on the preferred stock adjusted, the company would have enough surplus earnings to pay 5 per cent. on its common stock, which might be expected to sell at from $50 to $60 a share. The proposition made to the common stockholders to exchange, say ten shares of the old stock for one share of the new stock should be acceptable, since they obtain an income at once, and also a free market for their securities. In case the increased earnings of the company eventually make it possible to pay a high dividend on this reduced capital stock, the stock retired may be returned to the stockholders in the form of stock dividends, maintaining a dividend rate at a reasonable figure, and placing them again in their original position so far as concerns the par value of their holdings. This method was employed by the General Electric Company, which in 1898 reduced its stock 40 per cent., in 1902 returning the amount to its stockholders in a special stock dividend. Several corporations that were grossly overcapitalized at the outset have reduced their capital stock to a dividend-paying basis. The American Malting Company and the Distillers' Securities Company, among others, made such a reduction.

Reduction of capital stock to place it upon a dividend-paying basis can only be accomplished, unless the company is to be dissolved and its property taken over by a new corporation, by the consent of the stockholders, as prescribed by statute. This consent is comparatively easy to obtain when the stock has only a nominal value, and where the directors are able to

point out an immediate gain to the stockholders in taking the new securities.

The investment in plant, equipment, machinery, and office furniture is commonly referred to as fixed capital. On the other hand, the funds required to purchase raw materials, or other products needed in manufacture, to hire labor, and, in general, to keep the business operating until payments are received for goods sold, are spoken of as working capital, or revolving capital. It is impossible to say just what the correct relationship between fixed capital and working capital, in any business, should be. It differs in different lines of business. If, therefore, the organizers of a corporation wish to approximate the amount of capital necessary to establish an enterprise, they will do well to examine carefully the experience of others who have successfully passed the experimental stage in similar enterprises.

When the organizers have carefully developed their financial plan and have asked for the authorization of a certain amount of capital in their charter, they will also have to decide on the type of securities they expect to issue, either at the time of the formation of the corporation, or at a later date, after the experimental period is passed. The securities of a corporation consist of stocks and bonds. The funds raised by the sale of stocks are commonly spoken of as owned capital, or owned funds, because the stockholders are the owners of the corporation. On the other hand, the funds raised by the sale of bonds are referred to as borrowed capital; the owners of these bonds are known as creditors of the corporation.

The different kinds of stocks with their features and classifications have been discussed heretofore. Fig. 1 illustrates a certificate for preferred stock; Fig. 2 represents a certificate for common stock, having a par value; and Fig. 3 represents a certificate for common stock without nominal par value.

4. Mortgage Bonds.—At times, the organizers of a corporation may find that their property is such that they can readily pledge it as security for a loan. They will, therefore, obtain only a part of their capital by selling stock, and may

No._____ _____ Shares

FULL PAID AND NON-ASSESSABLE

American Steel Equipment Co.

INCORPORATED UNDER THE LAWS OF THE STATE OF PENNSYLVANIA

Authorized Capital Stock. One hundred and twenty-five (125) shares of Preferred Stock of the par value of $100 per share and One hundred and twenty-five (125) shares of Common Stock without nominal or par value

This Certifies That _____ is the owner of

_____ shares of the Preferred Capital stock of

AMERICAN STEEL EQUIPMENT CO

transferable only on the books of the Company by the holder hereof, in person, or by duly authorized attorney, upon surrender of this certificate properly endorsed.

The Preferred Stock may be issued as and when the board of directors shall determine and shall entitle the holders thereof to receive out of the net earnings, and the corporation shall be bound to pay, a cumulative dividend at the rate of, but never exceeding, eight per centum per annum, payable quarterly, semiannually or annually as the board of directors may from time to time determine before any dividend shall be set apart or paid on the common stock.

The holders of preferred stock shall, in case of liquidation, consolidation, reorganization or dissolution of the corporation, before any amount shall be paid to the holders of the general or common stock, be entitled to be paid the amount paid up on their shares and the dividends accumulated and unpaid thereon, but shall not participate in any surplus assets after paying off the whole of the paid-up capital

Such preferred stock, at the discretion of the company, shall be subject to redemption on any dividend date at $110 per share, together with any unpaid cumulative dividends.

The voting powers of the stockholders shall be vested exclusively in the holders of Common stock and the holders of Preferred stock, as such, shall be entitled to no voting powers whatsoever, nor shall they be entitled to notice of any meetings

IN WITNESS WHEREOF, the said Corporation has caused this certificate to be signed by its duly authorized officers, and to be sealed with the seal of the Corporation, this _____ day of _____ A. D. 19____

TREASURER PRESIDENT

FIG 1

INCORPORATED UNDER THE LAWS OF THE STATE OF DELAWARE

No._____ _____ Shares

CAPITAL STOCK $100,000.00 PAR VALUE OF SHARES $100.00 EACH

FULL PAID AND NON-ASSESSABLE

The General Bauxite Company

This is to Certify that_____ is the owner of

_____ Shares of the Capital Stock of

The General Bauxite Company

transferable only on the books of the Company by the holder hereof in person or by duly authorized Attorney upon surrender of this Certificate properly endorsed.

Witness the Seal of the Company and the signatures of its duly authorized Officers affixed this_____ day of_____ 19___

_____ TREASURER

_____ PRESIDENT

then mortgage their property to others, but at the same time keep possession of the property, and continue to operate it. In order to procure capital, it is customary for corporations to borrow upon their property up to a certain per cent. of its appraised value, by mortgaging it to a trustee, who is to hold the property in trust for those who lend the corporation their funds, namely, the bondholders. The corporation mortgage usually specifies, in considerable detail, what the debtors are to do with the funds raised under the mortgage by the sale of bonds. For example, it will state what type of buildings they are to erect, or what sort of property they are to buy, and specifies the interest rate to be paid on the bonds, as well as the time for repayment of principal. A copy of the bond, which is a special form of promissory note, issued under the mortgage, will be found in the mortgage itself. The bonds thus issued under a general mortgage, may be for fairly small amounts, usually ranging from $100 per bond to $1,000 per bond. Each holder of a bond is protected by the provisions of the general mortgage under which the bonds have been issued, which mortgage is kept in the possession of the trustee. The bondholder is entitled to receive interest as stated on the bond, and to have the principal returned to him when the bond matures, or falls due, at a future date. In case the debtor corporation does not fulfil the promise it has made in the mortgage, the trustee for the bondholders may either take actual possession of the property pledged as security under the mortgage, and operate it for the benefit of the bondholders, or he may sell the property covered by the mortgage, and apply the proceeds to pay the bondholders.

There are many kinds of corporation bonds issued by different corporations, taking their name very often from the type or mortgage that has been placed on the property under which mortgage the bonds have been issued. For example, a first mortgage bond on the property of a corporation means that the bond is protected, together with other bonds issued under this mortgage, by a first lien, or claim, on the property, over other creditors. A first refunding mortgage does not necessarily mean that this mortgage is a first mortgage on the

No. _____ _____ Shares

FULL PAID AND NON-ASSESSABLE

American Steel Equipment Co.

INCORPORATED UNDER THE LAWS OF THE STATE OF PENNSYLVANIA

Authorized Capital Stock: One hundred and twenty-five (125) shares of Preferred Stock of the par value of $100 per share and One hundred and twenty-five (125) shares of Common Stock without nominal or par value

This Certifies That _____ is the owner of _____ shares of the Common Capital stock of

AMERICAN STEEL EQUIPMENT CO

transferable only on the books of the Company by the holder hereof, in person, or by duly authorized attorney, upon surrender of this certificate properly endorsed.

The Preferred Stock may be issued as and when the board of directors shall determine and shall entitle the holders thereof to receive out of the net earnings, and the corporation shall be bound to pay, a cumulative dividend at the rate of, but never exceeding, eight per centum per annum, payable quarterly, semiannually or annually as the board of directors may from time to time determine before any dividend shall be set apart or paid on the common stock.

The holders of preferred stock shall, in case of liquidation, consolidation, reorganization or dissolution of the corporation, before any amount shall be paid to the holders of the general or common stock, be entitled to be paid the amount paid up on their shares and the dividends accumulated and unpaid thereon, but shall not participate in any surplus assets after paying off the whole of the paid-up capital.

Such preferred stock, at the discretion of the company, shall be subject to redemption on any dividend date at $110 per share, together with any unpaid cumulative dividends.

The voting powers of the stockholders shall be vested exclusively in the holders of Common stock and the holders of Preferred stock, as such, shall be entitled to no voting powers whatsoever, nor shall they be entitled to notice of any meetings.

IN WITNESS WHEREOF, the said Corporation has caused this certificate to be signed by its duly authorized officers, and to be sealed with the seal of the Corporation, this _____ day of _____ A. D. 19____.

_____ TREASURER

_____ PRESIDENT

SPECIMEN

property of the corporation, but means that an existing mortgage is to be paid off for the first time, by the proceeds derived from the sale of the bonds under the refunding mortgage. The mortgage which is being paid off, or refunded, may be a first, or it may be a fifth, mortgage on the property. It is clear that, as more and more debts are imposed on a corporate property in the form of second, third, fourth, and fifth mortgages, each additional debt, in case of insolvency or failure of the corporation, will have a weaker claim on the assets than the preceding, or prior, mortgages. These additional mortgages are commonly referred to as junior liens on the property.

5. The following illustration shows a bond of a corporation:

$1,000 No.....

UNITED STATES OF AMERICA
STATE OF DELAWARE

..... COAL COMPANY

6% First Mortgage Serial Sinking Fund Gold Bonds
Total Issue $100,000

KNOW ALL MEN BY THESE PRESENTS that the ..... Coal Company, a corporation created and existing under the Laws of the State of Delaware, for value received, is indebted to the bearer hereof in the sum of $1,000 in gold coin of the present standard, weight, and fineness of the United States of America, which sum it promises to pay in like gold coin on the .... day of ..... with interest at the rate of six per centum (6%) per annum, payable in like gold coin semiannually on the 15th day of March and September in each year on surrender of the interest coupons hereto attached as they shall respectively mature; principal and interest to be payable at the ..... Trust Company in the City of Philadelphia, State of Pennsylvania. This bond is one of an issue consisting of one hundred (100) bonds of like date and amount, but maturing serially in nine instalments, beginning March 15, 1922, and ending March 15, 1930, and numbered consecutively from one to one hundred, both numbers inclusive, amounting in the aggregate to One Hundred Thousand Dollars ($100,000), and all secured by a mortgage of even date herewith executed and delivered by said ..... Coal Company to the ..... Trust Company, as Trustee, to which reference is hereby made, for the terms and conditions upon which this bond is made and issued, for full description of the property mortgaged

to secure said issue of bonds, principal and interest, the after acquired property subject to lien of said mortgage, and also for the provisions relating to the sinking fund, and the remedies to enforce the collection of the principal and interest hereof, in event of default, said remedies being enforceable only by the Trustee for the benefit of the holders of all the bonds issued and outstanding under said mortgage.

The ..... Coal Company hereby reserves the right to anticipate, pay, and discharge at any interest period after the date hereof, and before maturity of said issue of bonds either the whole or any part of the aforesaid issue at one hundred and three per cent. (103%) of the face value thereof, and accrued interest upon thirty (30) days' prior notice given as provided in the aforesaid mortgage securing said bond, and this right to exercise from time to time, provided that if the right be exercised at any time at a less amount than the whole issue of bonds then outstanding, it shall be in the manner set forth in the mortgage hereinbefore mentioned.

This bond and all its rights, shall pass by delivery, and the holder shall have the right of a holder for value of a negotiable instrument, but it shall not become obligatory unless and until the certificate hereon endorsed has been executed by the Trustee.

In Witness Whereof, the said ..... Coal Company has caused its corporate seal to be hereunto affixed, duly attested, this seventh day of March, 19....

..... Coal Company.

By_____
President.

Attest:

_____
Secretary.

(Form of Coupon)

$30.00

..... COAL COMPANY

On the ..... day of ..... 19.., the ..... Coal Company will pay to bearer at the office of the ..... Trust Company in Philadelphia, Pennsylvania, in gold coin of the United States of America, thirty dollars, being six months' interest due that day on the first mortgage bond No..... Series .....

..... Coal Company.

By_____
Treasurer.

TRUSTEE'S CERTIFICATE

This bond is one of an issue of one hundred (100) bonds of One Thousand Dollars ($1,000) each referred to in the within mentioned mortgage.

..... TRUST COMPANY.

By_____

President.

The bond refers the holder to the mortgage deposited with a trustee, for full information as to his security. This mortgage will include a complete and detailed description of the property mortgaged. It will record the fact that the title of this property has been conveyed to the trustee for the bondholders. This conveyance, however, is not absolute, but conditional. If the company finally meets all its obligations to the bondholders, the conveyance lapses. It is, moreover, provided that although title shall rest in the trustee, use and possession shall rest with the company. In addition to promising to pay the principal and interest of the bonds, the company enters into a number of agreements such as to pay taxes, keep the property adequately maintained, etc., designed to prevent impairment of the value of the security underlying the bonds. In case the company defaults, not alone in payment of interest or principal, but in the keeping of any of its covenants as set forth in the deed of trust, then the trustee is empowered to enter upon the property and operate it for the benefit of the creditors; to sell the property and apply the proceeds to the satisfaction of the claims of the bondholders; or to apply for a receivership.

6. The following are a few typical provisions taken from a representative mortgage. Special attention is called to the italicized parts.

This indenture, made the first day of December, in the year ....., between ..... Company, a corporation duly organized and existing under and by virtue of the laws of the State of Pennsylvania, herein called the "Company"; party of the first part, and the ..... Trust Company, a corporation duly organized and existing under and by virtue of the laws of the State of New York, herein called the "Trustee," party of the second part:

WHEREAS, the Company has purchased the property, rights, and franchises of the Y. T. Company.

WHEREAS, *for the purpose of paying for said property, rights, and franchises, and for the other purposes for which the Company may lawfully issue its mortgage bonds*, the Board of Directors of the Company has duly authorized and directed an issue of bonds for the principal sum in the aggregate of $5,000,000 to wit: 5,000 bonds numbered consecutively from 1 to 5,000, each for the principal sum of $1,000.00.

AND WHEREAS, the execution and delivery of the mortgage or deed of trust as security for the payment of said bonds and coupons has been duly authorized and directed by the Board of Directors of the Company, with the assent and approval of its stockholders,

NOW, THEREFORE, this Indenture Witnesseth, that the Company, party of the first part, for and in consideration of the promises and of the sum of one dollar to it duly paid by the Trustee, party of the second part, and in order to secure the payment of the bonds aforesaid at any time outstanding, hath granted, bargained, sold, aliened, remised, released, conveyed, and confirmed, assigned, transferred, and set over unto the said party of the second part and its successors and assigns and their heirs forever:

All and singular the property, rights, and franchises of the party of the first part, the ..... Company, *whether the same be now or hereafter acquired*, INCLUDING:

1. All and singular the railways, tramways, and roadways which the company now has or may hereafter acquire, and each and every estate, right, title, interest, and property which the Company now has or may hereafter acquire, in or to railways, tramways, and roadways.....

2. All and singular the steamboats, steamships, ferry-boats, tugboats, floats, barges, vessels, and any other floating equipment.....

3. All and singular the coal lands and each and every estate, right, title, and interest, and property in or to coal lands wherever situated, which the company now has or may hereafter acquire, together with the buildings, fixtures, machinery, tools, materials, supplies, and stock thereon or therein, or used in connection therewith, or with the business thereof.....;

4. All and singular the leaseholds, leases, farms, and parts of farms, rights under leases, contracts or agreements, terminal, bridge, dock, and ferry rights, privileges and franchises, licenses, permits and privileges from the Government of the United States, or from any of the States, or granted by any municipal or governmental authority, and all other rights and franchises, privileges and immunities, general or special, *which the Company now has or may hereafter acquire.*

To have and to hold;—*in trust, nevertheless, for* the persons and corporations, associations, and partnerships, and for the benefit, security, and protection of the said persons, corporations, associations, and partnerships, who shall hold the bonds and interest coupons aforesaid, *or any or either of them*, and for the enforcing the payment thereof, when

payable, in accordance with the true intent and meaning and stipulations of this deed and of said bonds and coupons, and without preference of any of said bonds over any of the others thereof, by reason of priority in the time of the issue or negotiations thereof or otherwise howsoever.

Provided, however, and these presents are upon the express conditions, that if the Company, its successors or assigns, shall well and truly pay, or cause to be paid, the principal and interest to become due on the said bonds, to be issued as aforesaid—and shall well and truly keep, perform, and observe all and singular the covenants, promises, and conditions in said bonds or in this Indenture—then these presents shall cease, determine, and be void; otherwise, to be and remain in full force.

The mortgage then continues to set forth fully certain covenants and agreements that it makes with the trustee. These provide for certification of and delivery to the company, by the trustee, of 4,000 of the bonds immediately, to be used in part payment for the properties of the X Y Z Company, which the issuing company has purchased at a foreclosure sale; and for the certification in the future of the remaining 1,000 bonds as the company may require them for further purchases of property, which property will be included under the lien of the mortgage.

It is further agreed that the company shall pay all taxes imposed on its property, and further that:

So long as there shall be no default in the payment of any principal or interest of any of the bonds secured hereby, or in respect to any covenant or agreement, the company shall be entitled to possess, operate, manage, and use the property, rights, and franchises hereby conveyed, transferred, or assigned, as if this deed had not been made.

Equitable agreements, further, are entered into providing that the company may sell property no longer useful to it, and that the proceeds of such sale shall be used in improving or extending the remaining property "or otherwise in strengthening or increasing the security intended to be provided hereby."

In case of default by the company continuing for 3 months after demand on the payment of interest on *any* of the bonds, it is agreed that then:

The *principal* of *all* of the said bonds and all interest accrued and unpaid shall become and be *immediately* due and payable, either at the

election and upon the declaration of the Trustee, or at the election and upon the declaration of a majority of the bonds outstanding .....and the principal of all the bonds hereby secured shall become and be due and payable upon a foreclosure sale of the mortgaged property....."

Finally:

Upon the payment of principal and interest of all the bonds—and the reasonable compensation and lawful charges of the Trustee, the Trustee shall, on demand, execute and deliver any instrument which may be necessary or proper to satisfy the lien thereof, and *reconvey to the Company the estate and title hereby conveyed*, or intended to be, and to discharge the mortgage from the record.

The above deed provided, also, that when by resignation or otherwise a vacancy shall occur in the office of trustee, the holders of a majority of the bonds secured by the mortgage, then outstanding, may, upon agreement, select his successor.

7. Collateral Trust Mortgage.—A collateral trust mortgage is one in which the security of the bonds consists not of land, buildings, or equipment, of rights, franchises, etc., but of the securities of other corporations. Under these mortgages not merely the title, but also the physical possession of the property, passes to a trustee. So long, however, as the company does not default, the company is permitted to vote any stock that it may have deposited as collateral, and to receive the dividends and interest on the securities deposited with the trustee. In case of default the trustee may sell the collateral. The collateral trust bond is widely used in consolidations.

Collateral trust notes are similar to collateral trust bonds, save that they are short-term notes rather than bonds—long-term notes. Short-term notes may be unsecured; today, however, they are usually secured by collateral. Collateral coupon notes are notes whose security consists of a deposit of the interest coupons of bonds.

The following essential provisions distinguishing a collateral trust mortgage are taken from a representative mortgage of this type. The mortgage secures an issue of $200,000 of convertible bonds.

The mortgagor owns 995 shares of the capital stock of another company, the X Y Z Company. It transfers title to this stock to the trustee for the convertible bonds that are to be issued and to be secured by the deposit of this stock as collateral. Concerning the collateral, however, Article VII of the Deed of Trust provides as follows:

Section 1. The 995 shares of the X Y Z Company pledged hereunder shall be transferred and a certificate therefor issued to the Trustee in its name as Trustee, who shall be entitled to hold the same until the terms of this indenture have been performed, or such shares have been sold as herein provided (that is, in case of default by the mortgagor).

Section 2. The Trustee will from time to time on demand of the Mortgagor, execute and deliver to the Mortgagor suitable powers of attorney, or proxies to vote upon any of said shares of stock so deposited in trust, for the purpose of electing officers or conducting the business of the X Y Z Company; but no power of attorney or proxies shall authorize the voting of any of the shares of said Company in favor of the sale, mortgage, or other encumbrance or alienation of any of the mines or properties of the said Company.

Section 3. Any dividend that may be declared on the said shares of the X Y Z Company shall belong to and be paid directly to, and be the property of the Mortgagor, so long as it shall have performed all the covenants and conditions on its part under this indenture required to be performed.

The above is a relatively simple collateral deed of trust. Neither the par value, if any, nor the market value of the deposited stock is mentioned. Presumably its present and prospective market value in the aggregate is considerably greater than the par value of the bonds issued. It might have been provided that the ratio between the par value of the bonds and the market value of the deposited security should be maintained by addition to or substitution of the collateral. Note, however, the provision that the voting rights of the mortgagor are restricted, with the object clearly of maintaining the equity of the deposited stock.

8. Various Types of Bonds.—As investors do not like second, third, and fourth mortgages of the corporation, it is becoming a practice on the part of financial managers of corporations to use words or expressions that will make it appear

as though the bonds issued under a certain mortgage are high grade. The terms first 4 per cent. mortgage bonds, first and refunding mortgage bonds, prior lien mortgage bonds, general mortgage bonds, and similar expressions are used to designate different mortgages placed on corporate property, none of which, however, actually represent an out and out first mortgage.

There remains to be explained the issuance of debenture bonds and income bonds. In England the term debentures is used as a general term to cover the whole class of bonds; that is, the Englishman speaks of debentures where Americans speak of bonds. But in America debentures are considered to be a species of bond, namely, an unsecured bond. Some corportions may not pledge any specific property as security, but merely promise to the bondholders the payment of a definite amount of interest, and to return the principal at some future date, giving the bondholders the right of action against a corporation in case it does not fulfil its promise. It usually makes promises to the debenture holders, in respect to the way the borrowing corporation's business will be conducted, and these promises or agreements are contained in a deed of trust to one or more trustees for the benefit of the bondholders. Debentures are superior to preferred stock, which they resemble, in having a prior claim on corporate assets, which is enforceable by legal action in case of default. An illustration of a debenture bond is an issue by the New York, New Haven, and Hartford Railroad Company in 1904, which is in substance as follows:

> Fifty years after date the New York, New Haven, and Hartford Railroad Company promises to pay ..... or order, $1,000 at the office of its Treasurer, in the City of New Haven, Connecticut, and to pay interest thereon from date at the rate of 3½ per cent. per annum.

The value of debenture bonds is dependent on and measurable by surplus earnings over prior fixed charges. In many respects such bonds are not different from junior lien mortgage bonds, yet they usually bear a higher rate of interest than prior lien or first mortgage bonds. Debenture bonds are, on

the other hand, radically different from income bonds upon which interest is payable only when, as, and if earned, but whose principal is, like any other bond, payable at a definite date, and which may be secured by a mortgage.

The contracts that the company enters into with the holders of its debenture bonds may go far to compensate for the absence of mortgage security. It may, for example, be provided that no mortgage shall be placed upon the company's property unless the debenture bonds are included in the lien of the mortgage. Thus, in the offer of the debentures of the railroad referred to, it is provided that:

> These debentures will also provide, as far as lawfully may be, that if this company shall thereafter create any mortgage upon its now existing main lines of railroad between Woodlawn in the City and State of New York, and Springfield in the Commonwealth of Massachusetts, or its now existing main lines between New Haven in the State of Connecticut, and Providence in the State of Rhode Island, such debentures shall, without further act, be entitled to share in the security of such mortgage pro rata with any other obligations that may be secured thereby, and that any such mortgage shall expressly so provide.

An alternative, or additional, provision may be that, so long as the debenture bonds shall be outstanding, the capital indebtedness of the corporation shall not be increased. A typical agreement to this effect is quoted from an offer of debenture bonds:

> So long as any of said debentures or the interest warrants annexed thereto, shall be unpaid, no mortgage or other encumbrance shall be placed upon any of the property of the ..... Company, nor shall any other debentures be authorized or issued, nor any other bonds, except those provided for in the mortgages or deeds of trust outstanding May 1, 1910, and except bonds and mortgages to be authorized and issued to replace the bonds provided for in such mortgages or deeds of trust, in case the ..... Company may desire to refund the same or any of them, but in no event shall the par value of its said refunding bonds exceed the par value of the bonds which they shall be issued to replace, nor shall the rate of interest on any of such refunding bonds exceed the rate of interest upon the bonds which they shall be issued to replace, it being the meaning of this agreement that neither the total amount of the bonds at any time outstanding nor the rate of interest thereon, so long as

any of the said debentures or the interest warrants annexed thereto shall be unpaid, shall be increased; nor shall any notes be issued nor indebtedness authorized or created for any other purpose than the ordinary running expenses of the ..... Company.

Instead of entering into the first agreement exemplified in the foregoing paragraph, a corporation issuing debentures may retain the right to issue bonds under its various mortgages. This seriously impairs the security of a debenture, inasmuch as it can be satisfied only after the prior claims of mortgage bonds are met. Therefore the second provision exemplified is an especially desirable one from the point of view of holders of the debentures. Under the terms of such an agreement, the corporation, so long as the debentures are outstanding, is unable to issue any form of debt other than short-term notes or an inferior grade of debentures.

Another common form of agreement between debenture holders and the issuing corporation is that which provides as follows:

The ..... Company agrees that the proceeds of the initial $10,000,000 of said debentures shall be used only for additions and improvements to the plant of the company, and for working capital and other corporate purposes, and that the proceeds of the remaining $5,000,000 of said debentures shall be used only for the acquisition of additional property.

Through such a provision the company is obligated to expend the moneys acquired through the investment of the debenture bondholders, in a specified manner for the benefit of the property. It would be impossible under such a provision as the one exemplified for the company to use the proceeds of the debentures to retire its outstanding indebtedness or any part of it, or to use such proceeds as a means of providing moneys for the distribution of a portion of the company's surplus to the stockholders. Such uses, of course would be an injury to the debenture holders, so to prevent their being thus victimized we find this provision, very generally, which stipulates that all the money that the purchasers of the debenture bonds pay into the treasury of the company must be expended only so as to improve the company's property and therefore the net

earnings which the debenture holders rely upon for their interest.

Although debenture bonds are secured only by the general credit of the borrower and have no specific security, there may be, of course, a trustee appointed to represent the bondholders, and a deed of trust in which is recorded the agreements between the company and trustee or drawer up. In order to make debenture bonds more attractive, and to sell them at higher prices, many corporations have adopted the plan of making these bonds convertible into stock at a certain figure.

9. *Income bonds* are any bonds the interest on which is to be paid only when the company earns it. Ordinarily the interest on a bond is a fixed charge, by which we mean a charge on the earnings and assets, which must be met if the company is not to be deprived of its property by its creditors.

Income bonds are not widely used. They are issued sometimes in reorganizations, when the reorganization managers are not sure how much bonded indebtedness to burden the reorganized company with. If the new company prospers, the income bonds will receive their maximum interest and become valuable to their holders; if the company can do no more than pay its actual fixed charges, then the income bonds will, for the time, yield no income to their holders; on the other hand, the reorganized company will not again be forced into a new reorganization. Income bonds are usually secured by junior lien mortgages. Sometimes they are like preferred stock, but cumulative only when the arrearages of interest must be met before the company is permitted to pay dividends on stock.

In very few cases corporations have issued participating or profit-sharing bonds. Holders of income bonds may receive less than a stipulated maximum interest; but holders of participating bonds are assured of a stipulated minimum return, and entitled to more, depending on the earnings of the company and the terms of their contract.

There are times, however, when it may be expedient and safe to increase the bonded indebtedness, thus increasing fixed charges, in order to reduce the capital stock to a point where

it will be dividend paying. It has been said that where directors are able to point out to stockholders an immediate gain to be derived from reducing the amount of the capital stock outstanding, it is comparatively easy to obtain the consent of stockholders. When, however, the stock, even though not paying dividends, has a speculative value and a free market due to the spread of rumors concerning future prospects of larger earnings, or, perhaps, of a coming contest for control, or, again, of an impending consolidation, in such case it will be practically impossible to obtain the consent of the holders to a reduction of their holdings and, therefore, to the reduction of the stock to a dividend-paying basis.

10. Conversion of Preferred Stock Into Bonds.—Preferred stock outstanding may be reduced, if the stockholders will consent, by converting it into bonds. This method may be used when a 7 or 8 per cent. preferred stock can be replaced by junior lien bonds, which can be sold at fair prices at a period perhaps some years subsequent to the period in which the preferred stock was employed for financing.

The most notable example of such conversion in financial annals is that of the United States Steel conversion in 1902. The president of the company announced the plan in a circular to the stockholders, inviting their cooperation in a plan to raise $50,000,000 of new capital for the company. Of this amount, $25,000,000 was to be employed in the repayment of loans that had been incurred by the constituent companies for construction work, which had been in part made unnecessary by the merger, but which nevertheless could not be suspended because of advance commitments. The other $25,000,000 was to be used for improvements, which, it was estimated, would save the company at least $10,000,000 a year, in the long run.

The plan for raising this money, as proposed to the stockholders, was to "rearrange your corporation's capitalization (which, in round numbers, now consists of $300,000,000 of bonds, $500,000,000 of preferred stock, and $500,000,000 of common stock) by substituting for $200,000,000 of the preferred stock, $200,000,000 of sinking-fund sixty-year 5 per

cent. mortgage gold bonds, and by selling $50,000,000 of additional bonds of such issue for cash. As the preferred carries 7 per cent. dividends, while the bonds would bear but 5 per cent. interest, the $50,000,000 desired could, in this way, be added to the corporate resources, and the aggregate of the annual charges for interest and dividends, instead of being increased $2,500,000, would be decreased $1,500,000 as compared with the present sum total of these two requirements."

Under the operation of this plan each holder of preferred stock would have the right to subscribe to the new bonds to the extent of one-half of his holdings of preferred stock. Forty per cent. of each subscription would be payable in preferred stock, and 10 per cent. in cash. Or the subscription could be limited to 40 per cent., all payable in stock. This ambitious plan of the United States Steel Corporation, upon being assailed in the courts, was delayed for a long period by injunctions and then was finally abandoned—but not until $150,000,000 of preferred stock had been converted.

If the issuance of new bonds will not jeopardize the company's solvency, such conversion is justifiable. Given the assurance that the company's surplus earnings are and will continue to be sufficient to meet the increase in the fixed charges resulting from the new financing, the holder of common stock is advantaged in that, inasmuch as the interest charge on the bonds will be less than the payments due on the preferred stock, there is a reduction in the amount the company must pay out of earnings before a dividend can be declared on the common stock. The holder of preferred stock gains the increased security of bonds while accepting a lower rate of return

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INVESTORS IN CORPORATE SECURITIES

11. Classes of Investors.—Investors in securities of corporations fall into three main classes; first, those who are willing to risk their savings, hoping to realize large profits; second, those who will take a moderate amount of risk, but at the same time want some security for their investment,

and third, those who are willing to forego possible big speculative profits, and only ask for a definite rate of return on their investment, and the repayment of their principal in full at some future date.

Organizers and managers of business enterprises are fully aware of these three classes of investors, who furnish funds for organizing and developing business enterprises. They have devised various kinds of securities that will prove attractive to different investors. These securities range from decidedly speculative stocks in oil companies and land-improvement companies, to high-grade bonds of railroads, municipalities, and public utilities. Between these two extremes, there are many kinds of securities, involving different degrees of either risk or safety.

12. Speculators.—What kind of investor will buy highly speculative securities? Who are the investors in the stock of enterprises that have not yet firmly established themselves as going concerns, but which appeal to the imagination, and which, on investigation, often fall far short of being sound propositions? They are usually persons of moderate or small means who are willing to buy shares of stock in new companies at a low price, hoping that these shares will pay them large dividends and bring them big fortunes. These people have no knowledge of sound finance. They do not know how to judge the value of an investment. They are easily deceived by the dollar mark on the beautifully engraved stock certificate, and the "par value one hundred dollars" means one hundred dollars of actual value to them.

The promoter, or organizer, of a speculative enterprise is fully aware of the fact that there are people who have been influenced by stories of large profits made on small investments, and who have dreams of living happily and comfortably in their old age by investing a few dollars in stocks now. Such people hear, and want to listen to, only one side of the story. Their imagination can be stimulated very easily by a clever circular or by a glib talker, and when the salesman of speculative securities approaches them, they allow themselves to be

swayed very quickly. One of the real menaces to prospective investors in corporate securities is the salesman who has identified himself with a project, which to him seems a great opportunity and nothing else. He sees only huge profits, and no possible chance of loss. He may be absolutely honest and sincere in his belief that the project which he is promoting and in which he is selling securities is absolutely sound. He, therefore, does not hesitate to approach not merely strangers but even his intimate friends. He will tell them of his own faith in the securities that he is offering and will often back up his assertions by citing the extent of his own investment. Almost every one who has had a moderate amount of savings available for investment has, at some time or other, been approached by such a salesman. Thousands of people have been induced to invest their hard-earned savings in highly speculative business ventures year after year, and even at present it is contended that $3,000,000,000 are lost annually by people in the United States who invest their savings in pieces of paper, hoping that they will be able to make a large profit on their investment.

According to Einar Barfod, Deputy Secretary of Banking of Pennsylvania, enough money to pay off the war debts of the United States is thrown away every 4 years by the people of this country on worthless and fraudulent stock promotions. Taking the population of the United States at 120,000,000, the amount lost by investing in worthless securities each year is $25 for every man, woman, and child in the United States. This money is taken mostly from people with small means. It is very much like a tax, since it reduces the buying power of its victims, not to mention the worriment caused by loss of investments to those who had dreamed of big gains.

For a long time it was believed that the best way to teach individuals to use judgment in investing in doubtful securities of corporations, and to keep their eyes open, would be to let them learn by experience. A person who has lost his savings by investing in a fraudulent or speculative security may not be so ready to repeat his experiment. Since, however, new groups of prospects can be found from year to year, who can

be induced to speculate, the promoters find very little difficulty in discovering victims.

It has been contended that only a certain class of persons make up the so-called "sucker" list. Why try to protect these persons against the fraudulent stock promoter? If they do not lose their money in stocks, they will part with it some other way. After all, what does it all amount to? Why bother with a lot of people who are too ignorant to listen to a sound investment proposition and who lose only because they want too big profits and can be attracted only by the impossible?

To this argument Mr. Barford, in a recent newspaper article, replies that the speculative securities are practically all sold to people of moderate means and this class of people happens to be not only the largest and most important class of Americans, but the class with the largest amount of money. When America went into the World War in 1917 the annual income of the people of this country amounted to about fifty-three billion dollars, of which amount forty billion dollars went to people with incomes of less than $2,000 per year. It is this class, receiving 75 per cent. or more of the yearly income of all the people of the United States, which falls prey to the seduction of the glib stock salesman with his speculative offerings.

13. Blue Sky Laws.—The various states have passed laws intended to protect innocent investors against these promoters of "wild cat" schemes. Blue Sky Laws, so-called because the speculative promoter is popularly believed to capitalize and sell the blue sky, were first passed by the state of Kansas in 1911, and since then practically every state in the Union has developed some form of legislation to protect investors. As a rule, these laws provide that a corporation wishing to sell its securities within the state, must file with a state official, a statement as to the financial status of the business, the nature of its organization, and the financial basis for issuing stock, before it will receive permission to sell its securities in the state. In some states it is required that the salesmen of the securities of different corporations must also

be registered, and obtain a license to sell. Thus, for example, in the State of Pennsylvania under the Securities Act of 1923, every salesman of securities of business enterprises, with but few exceptions, must obtain a license from the state every year, and is permitted to sell only the securities of such companies as have been definitely approved by the Bureau of Securities. In order to get this approval, the companies may be asked to file with the Bureau of Securities a statement concerning their business organization, their financial status, their earnings over a number of years, and the type of business organization under which they are operating.

Objections have been raised to Blue-Sky legislation on the ground that it prevents the development of sound business ventures, that, at the time of their beginning, may be somewhat doubtful and speculative. It is argued that some of our very successful corporations would never have come into existence if, at the time of their formation, they had been subject to Blue-Sky legislation; because, weak and struggling as they were in their beginnings, they could never have obtained the permission of the state to sell their securities. It is a real problem to decide just where to draw the line between sound and unsound enterprises. Some business ventures that might possibly prove successful, but which at their beginning are decidedly speculative, probably do not come into existence under the restrictions imposed by present Blue-Sky legislation. At the same time it does not appear more difficult for any one to raise a moderate sum of money for a project that appears good and offers the possibility of large speculative profits than in the days preceding the Blue-Sky legislation. A person who has a fair speculative plan need not appeal to the public for funds. He can usually interest a few of his friends and obtain from them the necessary means to organize the enterprise without making a public offering of his stock. When he has established himself and has proved that his scheme promises well, he will not have difficulty in getting permission from the state to dispose of the securities of his company.

The speculative public provides funds not merely for highly dubious ventures that appeal to their imagination because of

their size and scope, but they also furnish most of the funds for many small businesses that have made a moderate beginning. After such concerns have passed through the stage in which capital is provided by those directely engaged in the enterprise, it is usually easy to find persons willing to provide further capital funds. The managers of small corporations sometimes lose sight of the fact that they do not have to go far from home in order to provide the necessary funds for their business needs. They have noticed large widely known corporations advertising and selling their securities over the whole country, and think that, in order to be successful, they must do likewise. They forget that many people in their own home town, who know something about the success of the small corporation, have good-sized saving-fund accounts, or possibly maturing shares in building and loan associations, and are thus in a position to furnish funds for the small business enterprise. The best place to look for purchasers of securities of small corporations is among those who are interested in the business, or among those who are acquainted with the management. After a number of these persons have become associated with the business either as stockholders or as bondholders, they will, in turn, help to reach others, and the list of prospective buyers of securities of such small corporations will grow steadily with the growth of the business.

The business manager of the small corporation will do well to consult his banker, who is usually better acquainted with the trade or business in which the corporation is engaged, unless it is a distinctly novel enterprise. A good word from the banker by way of indorsement of the project will often go a great way in winning new investors. Such an indorsement, of course, need not be a guarantee of the soundness of the enterprise, but simply a statement to the effect that, to the best of his knowledge, the company in question has been earning a fair margin on its investment and that it has always paid its debts promptly. This is the best indorsement a business can get. Small businesses that have established themselves, as a rule do not experience great difficulty in selling their securities to the local speculative public, who have faith

in the enterprise and who believe that it offers chances of large returns.

14. The Careful Investor.—The second class of investors in corporate securities consists of those individuals who are willing to take a moderate amount of risk with their funds but who, at the same time, want some assurance that their investment is fairly safe. They do not wish to buy common stock without any promise of a definite rate of return from year to year. A 7 per cent. preferred stock ordinarily offers a more attractive investment than a common stock that may have been paying 7 per cent. of its par value for a number of years. Holders of preferred stock have the first claim on the earnings of a corporation which are available for dividends, as compared with the holders of common stock. Since the preferred-stock contract usually provides that the holder of preferred stock shall receive a definite rate of return on his investment, based on the earnings of the corporation, the buyer of preferred stock feels that he is assured a definite rate of income. If, in addition to this assurance, he can buy into a speculative possibility, feeling that he has an opportunity to make an extra profit on his investment if the business prospers, which may be regarded as a speculative profit, such a security will prove doubly attractive.

Various plans are employed to combine the qualities of investment and speculative features in the same security. It is sometimes provided in the preferred-stock contract that the shares of stock may be converted into common stock. Buyers often attach much importance to this privilege of conversion. They buy the preferred shares, taking their regular rate of dividends as stated in their contract, and when, after a number of years, the business proves successful and is able to pay large dividends on the common stock, they will change their preferred shares into shares of common stock. In this way, they have assured themselves of a promise to receive a preferred dividend out of earnings while the business was developing, and then without any further investment have later made possible the obtaining of some of the larger profits.

Bonds are often sold with the same conversion privilege. When either convertible preferred stock or convertible bonds can be exchanged for common stock, their market value will usually rise with that of the common stock. The reason for this is clear. The common stock will usually advance in market price either because of higher dividends or because of privileged subscription. If common stock thus advances above par, the convertible preferred stock will tend to advance accordingly, since it can be exchanged for common stock. The common shares of a certain electric company, having a par value of $25 per share, at one time sold at around $40 per share, not only because they paid 8 per cent. on par, but also because of the anticipated new financing of the company to develop a promising water power project. The right to subscribe to new stock to finance a part of this project, which was extended to common-stock holders, helped to boost the value of these shares. The outstanding preferred stock, convertible into common stock, share for share, advanced to within a fractional part of one point of the common stock, not because it had any subscription privileges, but because it could be exchanged for common stock. Thus it is that the conversion privilege becomes a valuable speculative feature on certain kinds of securities.

Offers of convertible preferred stock are made almost daily by banking concerns. Spencer Trask and Company and Hitt Farwell and Company, bankers, offered $1,000,000 of 7 per cent. cumulative redeemable preference stock of Christie, Brown and Company, Canadian Banking Company, at $98 a share and dividend. These preferred shares were callable at $115 and dividends and were convertible into common stock in the ratio of three shares of common stock for each share of preferred stock.

An issue of $500,000 of 7 per cent. cumulative preferred stock of Isaac Silver and Bros. Co., Inc., Chain Stores, was offered by Geo. H. Burr and Company, broker, at par and dividends. The stock was convertible into common stock up to August, 1928, at the rate of one share for $1\frac{1}{3}$ shares of common stock. These are typical illustrations of offerings.

The same privilege has been extended to bonds of private business corporations, making them convertible into either preferred or common stock of the corporation at some time in the future, thus adding a speculative feature to these investment securities. This feature has made such bonds attractive to the speculative buyer. If, for example, a bond is a first lien against the assets of a corporation and is paying, let us say, 6 per cent. annually, it may be possible that the business is very prosperous and dividends on common stock of from 10 per cent. to 12 per cent. are being paid. The investor in such convertible bonds can then exchange his bonds at par, for par value stock, and instead of receiving only 6 per cent., possibly obtain from 10 per cent. to 12 per cent., in the form of dividends. These higher dividends would, in turn, be reflected in the somewhat higher market value of the stock than of the bonds. If the investor wanted to continue his investment in bonds, he could either sell his bonds, which would usually rise in value with the stock into which it can be converted, or the stock, if he had made the conversion, and invest his speculative profits in other bonds.

15. The Conservative Investor.—The third class of investors in corporate securities are those who forego speculative profits, and ask merely for a definite rate of return on the investment, and the return of the principal in full at some future date. This class of investors includes only a small percentage of the public at large. Individuals who have but small means will not, as a rule, invest their savings in bonds yielding them between 4 per cent. and 5 per cent. interest, particularly not in unlisted bonds. A difference of $\frac{1}{2}$ of 1 per cent., or possibly 1 per cent. in interest, is relatively unimportant to them and they would much rather, either place their savings in a good bank which will promise them 4 per cent. on their investment, or invest them in shares of building and loan associations, which promise a considerably larger return. During the war, many persons of moderate means were induced for patriotic reasons to invest their savings in government bonds. Some of these investors felt that they had performed

their patriotic duty by the government when they bought such bonds, and immediately sold them to brokers, often taking a loss of several dollars per bond. Today only a very small percentage of the millions of people in the United States who bought Liberty Bonds during the war, are still in possession of these bonds. It is doubtful whether bonds of corporations will ever become very popular with the small investor, so long as he has the opportunity of fairly safe investment in building and loan associations, yielding him a much larger return, or in saving funds yielding nearly the same rate of interest as bonds, yet making it possible to withdraw his deposits on comparatively short notice. Furthermore, bonds are usually of $100 denominations or more, and the average person who saves systematically will not be able to lay aside $100 at a time. He saves his smaller amounts out of weekly earnings by placing the savings in funds, which will accept payment of very small sums.

Nevertheless, corporation bonds as well as public utility and government bonds, enjoy a very wide market. Among those who invest in such bonds are those so-called institutional investors, which gather the small savings from the public into funds, and reinvest these savings for their clients. First and foremost among the institutional investors are the savings banks. They are large purchasers of high-grade bonds. Under the laws of most states their purchases are clearly limited to a definitely approved class of bonds, often referred to as savings bank bonds. For example, in Pennsylvania, Section 17, of the Act of May 20, 1889, which act provides for the incorporation and regulation of savings banks without capital stock, reads as follows:

> It shall be lawful for the trustees of any savings bank to invest money deposited therein only as follows:
>
> First. In the stocks or bonds of interest-bearing notes or the obligations of the United States, or those for which the faith of the United States is pledged to provide for the payment of the interest and the principal.
>
> Second. In the stocks or bonds of the Commonwealth of Pennsylvania bearing interest.

Third. In the stocks or bonds of any State in the Union that has not within ten years previous to making such investments, by such corporation, defaulted in the payment of any part of either principal or interest of any debt authorized by any legislature of such State to be contracted.

Fourth. In the stocks or bonds of any city, county, town, or village of any State of the United States, issued pursuant to the authority of any law of the State, or in any interest-bearing obligation issued by the city or county in which such bank shall be situated.

Fifth. In the bonds and mortgages on unincumbered improved real estate situate in this State.

Act approved June 28, 1923, P. L. 884, adds to the above list, Farm Loan Bonds issued by Federal Land Banks and Joint Stock Land Banks.

Insurance companies also spend vast amounts every year in buying sound investment securities which yield a definite rate of return. All institutions, such as trust companies, which hold funds for estates not only of individuals but also of various institutions, such as hospitals, asylums, educational institutions, churches and the like, invest these trust funds in securities of public utilities, and in government bonds.

A tendency has developed among individuals of large means to invest in the bonds of state and municipal governments throughout the United States because, under the present tax laws of the federal government, the income derived from investments in such governmental securities is not subject to the high income rates. The market for all such securities has, therefore, been extended from institutional investors, to which it was formerly confined, to thousands of private individuals.

The manager of a corporation will do well to keep carefully in mind the different classes of investors in the securities of corporations. By adapting the securities of corporations to the various types of investors, he can find the widest possible market for them, and thus obtain sufficient funds for his enterprise.

MARKETING SECURITIES

16. Avenues for Sales.—As a rule, the amount of capital subscribed by the original stockholders in a new corporation is merely enough to organize the business, and establish it as a going concern. Sometimes it does not even suffice for this purpose. Therefore, immediately after the corporation has been organized, it becomes the problem of the managers of the corporation, the directors, to obtain additional funds with which either to buy fixed capital, or to provide working capital until payments are received from the sale of products. These additional funds are obtained by the sale of either stock or bonds in one of the four following ways: 1, the securities may be sold to the present stockholders, or to certain outsiders who know about the business in question, and who want to invest in it; 2, they may be sold to the public at large; 3, they may be sold to a large banking house, which will in turn sell them to its customers, smaller bankers; 4, they may be sold to banking and brokerage houses, which will sell them through the stock exchanges in different cities, to the investing public.

The first of these methods may be successfully used by small close corporations. A close corporation is one that is owned by a small number of people, often by the members of a single family. If it is intended to keep the ownership of the corporation in the hands of a few members of the family, the problem of raising additional funds is a family affair, and, in such corporations, the members of the family will buy the additional stock, and thus provide the funds necessary to continue and expand the business.

17. Rights.—Even a corporation owned by a large number of people will, from time to time, sell its securities directly to its stockholders, and thus provide additional capital. In corporate affairs the stockholders have the right to subscribe to additional stock issues before any such stock is offered for sale to the outside public. The price at which the stockholders may buy additional stock in their corporation is usually below

the market price of the stock. The right to buy new stock at a price below the market price, which is extended to stockholders of record, is called a subscription right. If a stockholder is not in the position to take advantage of this privilege, he may sell the right to someone else. If the stock is listed (that is, quoted or dealt in on one of the stock exchanges), experts will usually figure the value of such rights to the stockholders. The amount thus computed will be listed on the exchange as the selling price of the rights. A simple method of computing the value of the rights on the part of the investor in the stock of a corporation, which is about to make an allotment of new stock to its stockholders, is as follows:

Suppose John Jones owns 100 shares of stock of the X Electric Company, which, at the present time, has a market value of $150 per share. He is to have the right to subscribe to new stock to be issued by the corporation, to the extent of 50 per cent. of his present holdings, at $125 per share. For how much would he sell this privilege to an outsider, and how much would an outsider be willing to pay for this privilege. John Jones would figure as follows:

100 shares at $150 = an investment of	$15,000.00
50 shares at $125 = an investment of	6,250.00
Total cost of 150 shares =	$21,250.00

Cost per share = $141.66.

Since one share of the outstanding stock entitled its holder to subscribe to one-half a share of the new stock (50 per cent. allotment of the new issue) this right will be worth one-half the difference between $141.66 and $125, or one-half of $16.66; namely, $8.33. Thus John Jones would sell his rights for an amount approximately equal to $8.33 per share.

Sometimes the stockholders who receive such rights, may not be able to finance the buying of all the shares of stock alloted to them. At the same time, they may not want to sell all the rights. They will, therefore, take their profit on the sale of some of the rights, and buy up, at the allotment

price, the number of shares which they can buy with this profit. Thus, in our example, John Jones can make a profit of approximately $8.33 on each right which he receives. He could, therefore, sell 47 of these rights, and with the proceeds buy at least three shares, using the remaining three rights, at $125 per share. This is equal to receiving three shares of stock free, because of the good business rating of the company of which he is a part owner, which causes its stock to sell above its par value, $125.

The directors of corporations prefer to issue subscription rights to the stockholders because it helps to develop a good feeling between the management and the stockholders. The stockholders who receive these rights feel that they are getting something for nothing. On the other hand, the method of selling stock below the market price has been objected to, on the ground that it develops speculation in stock, rather than safe and sound investment. At the present time many stocks are listed on the security market at a price considerably higher than the price that yields a fair return on the investment. Stocks are selling at $45 per share, which, on an investment of $45, should yield only a little over 3 per cent. and buyers of such stock are buying it, not so much because they think that the dividend rate is going to be raised in the immediate future, but because they feel that the particular corporations are going to expand and finance their expansion by making a stock allotment to the stockholders of record at a price considerably below the present market price on the stock. This will mean that the rights to subscribe to additional stock will have a decided market value, and speculators on the market are taking advantage of this supposed opportunity. When, for example, it appeared that a water-power project was about to be financed by a certain electric company by a possible 100 per cent. stock allotment at par ($25) to the stockholders, the outstanding stock rapidly rose in the market. Speculators bought the stock in anticipation of the allotment, and its market price soared to over $45 per share. But when definite objections to the project caused at least a temporary delay in its development, the market price of the stock broke to below $38 per share.

In connection with the advantages to be derived from being able to offer privileged subscriptions appears another advantage of using no-par-value stock in the financial plan. For when there is only par-value stock, the fundamental requirement for offering a privileged subscription may not exist. For in order that the stock may be taken by the old stockholders the market price of the outstanding stock must be well above the price at which the new stock is offered. But most state laws prohibit the original issue of stock of a corporation at less than par, so unless the market price is so well above par that it will remain above par in the face of an increased supply of stock, a privileged subscription right is of no premium value. But with stock of no par value, on the basis of any market value whatever, even $1 per share, a privilege can be offered to the holders.

18. Employe Stockholders.—To provide funds for expansion, corporations will not only sell stock to the stockholders of record, but it has become the practice of many companies to sell stock to their employes.

In 1922, 128,000 employes of the Bell Telephone system (about 55 per cent. of the total number of employes), were already either stockholders of record, or were paying for stock on the subscription plan. In 1921, the United States Steel Corporation sold more than 255,000 shares of common stock to more than 81,000 employes. These were about one-third of the total number of employes and the average purchase per employe was three shares at a combined market value of $243. It is estimated that now probably more than one-fifth of the stock of the United States Steel Corporation, or approximately 1,000,000 shares, is held by employes, who rarely appear to sell the stock once purchased. More than one-third of the 47,000 shares of Swift and Company, meat packers, is held by its employes.

It is a common practice to allow employes to pay for such stock on the instalment plan, and a certain amount is deducted from their wages each week by way of payment. Sometimes it may be provided that a certain fund shall be set aside, out of

the earnings of the corporation, with which to buy stock for the employes, and to give this stock so purchased to those who have rendered notably faithful service over a series of years.

The stock issued to employes does not always give the stockholders a voice in the management of the business by allowing them to vote for the directors of the corporation. Frequently, however, the stock sold or given to them is voting stock and the employes are an influence on the directorate. It is sometimes provided in purchase contracts that if the employes leave the business the stock must first be offered for sale to the issuing corporation, and only if it declines to repurchase it at a stated price may the employe owner offer it elsewhere.

A corporation can rarely depend upon its employes to supply needed capital by purchasing its stock. Organizations that encourage employe purchases do so chiefly with a view to interesting their employes in the business; stimulating them to efficient service with the hope of increasing the profits that make for increased value of the stock and increased dividends; decreasing labor turnover; and abolishing profit-destroying strikes. A management, however, may seek the support of employes in order to keep itself in control. In Philadelphia the employes of the Philadelphia Rapid Transit Company bought and controlled enough stock to enable them to keep the president of the company in office at a time when certain powerful ownership interests were apparently on the point of ousting him. However, in the case of a well-known confectionery company, the stockholding employes sold their shares to a rival interest, which then ejected the management that had introduced the stock ownership plan.

It is quite conceivable that employe ownership may spread and become a potent factor in electing and controlling boards of directors. But it seems that it is best adapted to public utilities where the hazards of industry are not so great. In the industrial field it may not be so satisfactory. There have been cases where employes have been much disgruntled as a result of reduction of dividends paid on their stock; or where, a dividend having been passed because of unavoidable financial necessity, there was disappointment and irritation among the employes.

At the end of the World War, in this country, when the depression appeared, employe owners of stock in some large companies had sunk their savings in the stock and were unable to carry it all. They lost heavily. But aside from industrial depression, there has been more than one case where employes have lost savings by investing, upon persuasion, in the stock of their small company when failure was imminent.

19. Customer Stockholders.—Corporations may also seek to sell securities to their own customers. This is impracticable, of course, for a newly organized company, and is used mostly by public utilities. The customer of local public utilities generally have some familiarity with the business and earning power of these utilities. The utility may be eager to have a certain amount of these securities widely held in the local community in order to decrease the possible protests of the public and their representatives when rates are due for an increase. The public is attracted by the idea of the cooperative distribution of profits to the customers, who make the profits possible. The corporation is assured of the continued patronage of the customers who hold stock.

The corporation, especially the public service corporation, which seeks to sell to its customers, may reduce enormously the usual expense of floating securities. It may use its own employes as its only selling agents, and give them a small commission, say 1 per cent. The street car company may advertise the sale, as the Philadelphia Rapid Transit Company did, by having the car conductors give out handbills in the cars, and have them take subscriptions in line of duty, without commission.

In 1922, for example, the New York Telephone Company offered publically $25,000,000 par value 6½ per cent. preferred stock, its employes, receiving a 1 per cent. commission, to be the only selling agents. Total applications from 107,000 persons, the majority desiring from one to five shares, amounted to $82,500,000. Allotments had to be scaled down. No applicant received more than five shares; and about 80 per cent. of the 107,000 applicants received only one or two shares.

The company was successful in getting a wide distribution of ownership among the general public,—its customers. Its official statement said that

> The main purpose of our offer was to secure a wide distribution of the stock among our subscribers, particularly among persons who ordinarily are unable to invest their savings in high-grade securities. We made it possible for subscribers to secure the stock on one payment or on small monthly payments, and the response shows that the opportunity was very generally recognized.
>
> We have reached people, who, in the aggregate, have an enormous buying power, and who, when fairly dealt with, will support their public utilities both in the ordinary conduct of the business and by investing in their securities.

20. Small Investors.—Selling securities in small amounts to a large number of small investors is one of the principal advantages to be derived from selling to customers. Small investors are not in the speculating class. Most small stockholders buy for investment; they hold on. The result is there is no constant turnover of securities on the market, which would result in a continued fluctuation of price. There is the danger, however, that these small investors may, in the first scare of rumor or warning, which may, perhaps, have no real foundation, become suddenly panic-stricken and throw their securities in the market, thereby causing a tremendous fall in the price. A corporation, however, may circularize all its small security holders informing them that it will be glad to have them offer their shares to the company before offering them elsewhere, if the holder ever desires to sell. This device of intimating unofficially to the small holder that the company is back of him has been demonstrated to be psychologically sound and effective, although in reality it means nothing. The small investor knows little of finance. The plan of selling to small investors was used by the H. H. Franklin Company, when, between 1919 and 1922, they sold $6,500,000 of stock, par value, by direct selling, without the use of a middleman, to 7,000 shareholders—an average of only about $1,000 to each —at a selling cost of about 5 per cent. at a time when selling the same securities through the organized channels of security selling would have cost anywhere from 7 per cent. to 15 per

cent. A par market for these securities has been maintained. During the trying period of 1921, when many stocks were seriously depressed, less than $100,000 of a total issue of the $5,000,000 then sold of the Franklin stock came on the market, and the stock stood firm at par.

21. The Public at Large.—Corporations sell their securities not only directly to their stockholders or employes, or to their own customers, directly, but at times also sell directly to the public at large. In order to do this, they must look for prospective buyers and develop a selling campaign. The problem of interesting the public at large in a security issue may be approached as follows: first, by getting a list of prospective buyers; second, by approaching these buyers and arousing their interest in the business; third, by making the buyers want to take a part in the business; and finally by closing the sale.

It often happens that a young man or a group of inexperienced business organizers will hit upon the idea that advertising is the easiest and quickest way to get the names of prospective buyers for their securities. They will spend large sums in display advertising, stressing big possibilities and large profits. This method of getting prospects is seldom used today by sound business organizers, but chiefly by those who want to sell securities in speculative ventures. It is, therefore, not to be advised as a means of getting prospects for a sound enterprise, for it will not only reflect on the business, but may also prove very expensive.

A safe method for a business that is not a highly doubtful or speculative venture is to send a circular announcement of the business scheme to a selected group of persons or business houses. The only objection to sending such a circular is, that it may arouse suspicion, among those who receive it, that the corporation is in financial difficulty and does not have the ability to raise the necessary funds among its own stockholders.

Perhaps the best method of finding prospects for securities, especially of small corporations, is by personal solicitation. If the right kind of salesman is secured by the organization, it

should not be difficult to sell fairly large amounts of securities, particularly if the business is one that offers a fair rate of return. But even this method of selling securities to the public direct cannot be relied on too much by a young organizer. As a matter of fact, it is becoming more and more difficult to interest the public at large either by advertisement, circular, or personal approach in industrial corporations that offer a sound investment and are not speculative. So long as there are possibilities of large profits from a speculative venture, some individuals, anxious to take a chance, can always be found. But when it comes to selling a sound investment, promising only a reasonable or fair rate of return, the speculative buyer will almost always say, "Why don't you sell these securities to a banking house? Banking houses are always looking for such good investments." If a list of prospects has been compiled by the corporation, the problem of arousing their interest in the project is one that should be handled with tact and care. As has been indicated, there is always danger of presenting a project too optimistically. Most sound business concerns today interest prospective buyers of their securities in the business by displaying all the important facts about their business in a prospectus. A prospectus should be merely a statement of the exact condition of a business, presented for information to prospective investors. It usually states the nature of the business, its financial status, investments, gross and net earnings, purpose for raising new funds, security to be offered to subscribers to new capital, and similar pertinent facts. In order to give it additional weight with prospective investors, the names of reliable firms who have carefully audited the books of the company, and of engineers who have appraised the property, are added to the prospectus. With a carefully prepared prospectus and a good salesman, many prospects at large can be converted into investors in the securities of business corporations.

22. The following prospectus is intended to invite subscription to an issue of stock of the X Y Z Briquette & Coal Company:

First Offering

XYZ BRIQUETTE & COAL COMPANY
(A Common Law Trust)

100,000 Common Shares
No par value

CAPITALIZATION

	Authorized	Issued
8% Preferred, cumulative shares, par value $100	$250,000	$150,000

	Authorized	To be Outstanding
Common shares, no par value.....	1,000,000 shares	500,000 shares

Preferred shares are redeemable in whole or in part on any date, after May 1, 1927, at $110. A sinking fund of not less than 5 per cent. of all net earnings will be maintained, beginning January 1, 1926, for redemption purposes.

The Company has no bond, mortgage or note indebtedness. $150,000 of Preferred shares and 217,000 Common shares have been issued in full payment for the Company's property.

Summarizing from the more detailed description given herein by Mr. J. S. Jones, President of the XYZ Briquette & Coal Company, we call attention to the following facts:

HISTORY. The XYZ Briquette & Coal Company was organized for the purpose of taking over the business and properties of the AB Coal Company and to manufacture anthracite fuel for domestic use. It will also acquire other similar properties.

The AB Coal Co. has been in the business of reclaiming and selling river coal since 1917, and is, in point of coal deposits on its properties, one of the most important—if not the most important—enterprises of its kind in the industry.

BUSINESS. The XYZ Briquette & Coal Company proposes to manufacture briquettes from anthracite coal which will be superior to the natural product and will cost the consumer less.

The Company owns a vast deposit of high-grade anthracite aggregating many millions of tons, particularly adapted to briquetting purposes.

Its property has the advantage of shipping facilities on both the Pennsylvania Railroad and the Philadelphia and Reading Railway, and is within a short haul distance of 30,000,000 users of anthracite in domestic sizes.

The initial briquette manufacturing unit of the Company's plant is to have a rated capacity of 100,000 tons a year. As the demand warrants, additional plant units will be erected.

The demand for XYZ briquettes is assured.

VALUE OF PROPERTY. The property of the Company consists of leaseholds, washeries, buildings, and equipment valued at upwards of $200,000,

and a deposit of coal that is listed at the low price of 20 cents per ton on a conservative estimate of 5,000,000 tons, or $1,000,000.

Considered from the standpoint of the recovery of present commercial sizes only, the operations of the Company have been profitable; but with the opportunity to retain for conversion into briquettes the sizes which have heretofore been discarded as waste, the coal deposit value is vastly increased.

Earnings. In quantity production the cost of X Y Z briquettes is about $3.00 per ton; and the average market price for several years past would yield a profit of from $3.00–$4.00 a ton. Assuming, however, for conservative calculations a profit per ton of only $2.00 and an annual output of 100,000 tons, the profits applicable to the Common Shares would be from $2.00–$4.00 per share.

The cost of the initial plant unit will be about $160,000; and additional units about $140,000. With several units in operation the cost of production will be less.

Purpose of Issue. The purpose of this issue is to procure funds with which to erect and equip the first unit of a briquette plant with a rated yearly capacity of 100,000 tons.

Management. The management of the Company is in the hands of a Board of Trustees. The men who comprise this Board are representative business men whose activities and affiliations are confined for the most part to the coal business.

The unsold portion of this issue is offered
At $2.50 a Share

SMITH & COMPANY
Stocks and Bonds
Philadelphia, Pa.

The statements contained herein, while not guaranteed, are based upon information believed to be accurate and reliable.

June, 19...

X Y Z BRIQUETTE & COAL COMPANY

June 6, 19...

Mr. L. Smith, President,
Smith & Co.
Dear Sir:

Referring to the plans of the X Y Z Briquette & Coal Company and the present proposed financing, I take pleasure in advising you as follows:

History and Organization. The X Y Z Briquette & Coal Company was organized as a Common Law Trust in August, 19.., for the purpose primarily of taking over the business, plants, and properties of the A B Coal Company and to turn a vast deposit of raw material into a product of great commercial value.

The A B Coal Company is one of the larger organizations engaged in the industry of reclaiming coal from the creeks of the anthracite region. Its first washery was installed and has been in operation since 1917 and at the present time there are two of these plants which, with leaseholds, are valued at over $200,000. I am advised that the A B Coal Company has been successful in the recovery and sale of its coarser sizes of coal, despite the fact that 70 per cent. of recovery was lost because the coal, though purest carbon, was too small for commercial use. For several years this coarser river coal has been sold to many of the most important coal users along the seaboard.

The handicap of a loss of 70 per cent. of all coal recovered, in connection with economic conditions throughout the country that led to two or three years of business depression, caused the management of the Company to seek some means of stabilizing its business; of utilizing uncommercial coal sizes, and creating greater tonnage value for its output.

It was recognized that the Company's deposits were a high-grade anthracite with less of the impurities prevailing in run-of-mine coal, and that the cost per ton for recovery was about one-tenth the cost of the average anthracite mining operation; that the location of the deposits, as to rail transportation, was especially favorable, and that within a short-haul distance, there were 30 millions of stove and furnace coal users. The question was how to create a commercial size of lump coal out of a million tiny particles of pure carbon, and at low cost.

Business. We propose to build at once a Briquetting factory on the Company's property with an initial capacity of 100,000 tons a year of high-grade anthracite briquettes. This plant will be so constructed that units of equal capacity can be added as the expansion of our business demands. Work on the initial unit is now under way and we expect to begin Briquette production by September, 1923. The Company's washeries will be used as "feeders" for the Briquette plants. The 70 per cent. of fine-coal recovery, now lost, will be turned into $6.00 a ton coal at a cost of $3.00 for recovery, treatment, and manufacture, and the coarser coal sold to the trade as at present. We have every reason to believe that the demand for our briquettes will be so great that other units will be required in the near future.

For the year 1922, ending March 31, the Anthracite coal production was 67,000,000 tons; for the year 1923, ending March 31, 44,000,000 tons. The retail price of anthracite in 1913 was $7.00 a ton. Ten years later it had advanced to $15.00 and $16.00 a ton. Increasing population, gradual decrease of natural supply, higher wages and wastage at mines, are factors which constantly push the price higher. The American public is anxiously seeking a staple substitute for this high-priced fuel.

Europe is far ahead in this respect. The briquette tonnage in France for 1921 was about 3,000,000 tons; Germany 34,000,000 tons, and Hungary 25,000,000 tons. For years, preceding the war, European briquette companies declared from 15 per cent. to 20 per cent. dividends on their capital. George Otis Smith, Director, U. S. Geological Survey, says "We must have an artificial anthracite; we must supply a substitute without delay." Bulletin 58, U. S. Government Bureau of Mines report gives 15 "Advantages of Briquettes Over Natural Fuel." X Y Z Briquettes are in many ways superior to anthracite coal and can be manufactured at a profit, and yet sold to the public at from $2.00 to $3.00 a ton under the market anthracite price.

There are about 5,000 retail dealers in the anthracite burning section of the East. Although only about one-fiftieth of these dealers have been approached, over one-half of the output of our first unit has been optioned at market price at time of delivery. I estimate that plants with a capacity of 1,000,000 tons will be necessary to supply the demand for our Briquettes.

The demand for our coarser sizes of river coal fluctuates from year to year. Operation of our washeries is now being held at a minimum pending the completion of our Briquette factory, as it would be poor business to sacrifice the fine coal for the sake of marketing the coarse. Our coarse coal output at present is restricted to from one to three cars a day.

Value of Property. The property of the X Y Z Briquette & Coal Company consists of leaseholds, washery plants, and equipment and a vast deposit of river coal. These plants, with original cost of leases on which they work, I estimate to be worth over $200,000 and have been constantly kept up to standard. They are located where they will best serve in connection with our Briquette plant, and represent one of the great advantages we have over other Briquette enterprises. The Plant will have the advantage of freight facilities on two railroads, the Pennsylvania and the Reading.

The coal varies in depth from 3 to 20 feet, and based upon borings, tests, and conclusions of recognized engineers, I estimate the quantity of coal to be at least 5,000,000 tons. The supply, however, is practically inexhaustible, as for every ton we move, other coal is deposited. Above the Company's property there are 26 large coal mining operations. From these there is a constant flow of tiny specks and bits of coal that gravitate to the Company's acreage, and that, in the aggregate, amount to an enormous tonnage, already mined and paid for, delivered, and ready for our steam shovels. This vast deposit, although for our purpose worth very much more, is listed in this prospectus at 20 cents per ton on an estimate of 5,000,000 tons, or $1,000,000.

The coal after being prepared for use in the Briquette plant will run from 15 to 18 per cent. ash and less than 1 per cent. sulphur.

This high-grade raw material in combination with our binder will be converted in our plant from tiny bits of pure carbon into fuel for stove and furnace use, superior to the best anthracite natural product and at less cost to the consumer. The following are the qualities we guarantee in our Briquettes:

They burn with no smoke and no odor;
They can be used in any ordinary grate;
They produce greater heat per ton than anthracite coal;
They ignite more quickly and hold the fire longer;
They are not susceptible to spontaneous combustion;
They produce no clinkers;
There are no sparks;
They burn gradually to a clean ash;
They are weather proof;
They are far cheaper than anthracite.

I value the present assets of the X Y Z Briquette & Coal Company at $1,200,000.

Capitalization. Upon completion of the financing as at present proposed, the capitalization will be as follows:

	Shares Authorized	Shares Outstanding
Preferred shares 8 per cent. Cumulative par value, $100	2,500	1,500
Common shares, no par value	1,000,000	500,000

The Preferred Shares are entitled to an 8 per cent. Cumulative Preferential dividend, after which net earnings will be available for Common Share dividends. The Preferred Shares are redeemable after two years from May 1, 1925, at any dividend date at $110. A sinking fund of not less than 5 per cent. of all net earnings will be created and maintained for the redemption of Preferred Shares beginning January 1, 1924.

For all the assets acquired, the X Y Z Briquette & Coal Company has transferred 1,500 of its Preferred Shares, par value $100 per share, and 217,000 of its Common Shares, no par value. Most of the holders of the stock are the former owners of the A B Coal Company and some of them are now Trustees of the X Y Z Briquette & Coal Company.

The plan of the Company contemplates the sale of its Common Shares in series of 100,000 shares. The first public offering is 100,000 Common Shares at $2.50 per share. 17,500 shares of this offering are a part of the consideration paid for the Company's property. The proceeds from the sale of 83,000 shares will be used principally for the construction and equipment of a Briquette plant, which will have a rated annual capacity of 100,000 tons.

Offering of additional series of the remaining unsold Common Shares will be made at $5.00, $7.50, and $10.00 a share in such volume as the need for expansion may dictate. It is our intention to prepare for the erection and equipment of other briquette plant units, and to provide funds with which to acquire additional coal properties and to extend the Company's present coal recovery equipment.

The cost of the initial plant I estimate at about $160,000.

Earnings. In quantity production, viz.: the output of one factory unit, the cost of X Y Z Briquettes, I estimate, is $3.04 per ton. This is made up of the following items:

1. Coal	$ .50	6. Oils, waste, etc.	$ .05
2. Binder	1.20	7. Repairs and upkeep	.10
3. Power	.35	8. Insurance, taxes, etc.	.03
4. Labor	.35	9. Depreciation	.11
5. Executive office and sales	.30	10. General supplies	.05

Considering the present market prices of anthracite coal, our Briquette should sell for about $7.00 a ton. Taking as a basis a cost per ton of $3.04; a receipt of $7.00; and a 100,000-ton factory unit that cost complete with expense of financing, etc., $200,000, our gross profit would be about $400,000, or $4.00 a share on the first issue of 100,000 Common Shares.

I know from experience that our manufacturing cost per ton is liberal and that dealers are ready and anxious to secure our briquettes. This is evidenced by the fact that over one-half the output of our first unit is already optioned in advance to less than 150 coal merchants who have bought shares in the Company.

I estimate the proceeds from sale of 200,000 additional Common Shares will be sufficient to build and equip nine units, making a total plant of 10 units, with a capacity of 1,000,000 tons of briquettes per year. At such time, there would be 500,000 Common Shares outstanding. Based on an annual output of 1,000,000 tons at a net profit of only $2.00 a ton instead of $3.00 or over, the net income, I estimate, would be $2,000,000 or $4.00 per share on outstanding shares. The plan and scope of the Company is broad enough for all eventualities, but the intent is to sell only such number of shares as will be necessary to provide the means to meet the demand of consumers, and not to build factories before output is optioned.

Management. The affairs of the Company are in the hands of its Trustees, men of broad experience in the coal business as operators and dealers. Their knowledge of mining, manufacturing, and marketing of coal and coal products is practical and extensive and their money interest in this enterprise is represented by substantial amounts.

Yours very truly,

(Signed) J. S. JONES, President.

OFFICERS

J. S. Jones, President
James Kennedy, Vice-President
Andrew Black, Secretary and Treasurer

TRUSTEES

J. S. Jones ..... Trenton, N. J.
President ..... J. S. Jones, Inc.
Director ..... ——— Evaporator Company
James Kennedy ..... Coal ..... Philadelphia
President ..... ——— Coal Mining Company
Treasurer ..... ——— Coal Company
Treasurer ..... ——— Company
President ..... ——— Coal Company
Andrew Black ..... Wholesale Coal ..... Philadelphia
Secretary ..... ——— Company
Secretary and Treasurer ..... ——— Company
John Brown ..... Coal ..... Philadelphia
Treasurer ..... ——— Company
Vice-President ..... ——— Coal Company
John Walter ..... Coal ..... Philadelphia
President ..... ——— Coal Company

Since the method of selling securities to the public direct may prove very costly to the business, and second, since it is highly doubtful whether it will prove successful, this method is being used less and less by good sound business enterprises. If the proposition is one that is safe within reasonable limits, it should not be difficult for the organizers to interest a banking house in the proposition and thus be assured of definite funds at a definite time. Offers of securities of small, as well as of large, concerns by reliable banking houses, are listed every day on the financial pages of our daily newspapers and financial journals.

23. Dealers in Securities.—There are different kinds of dealers in securities of corporations. We may divide them into three classes: wholesalers, retailers, and retailers of specialties. Large banking houses, such as J. P. Morgan and Company, Speyer and Company, Kuhn, Loeb and Company, in New York, are usually spoken of as wholesalers of securities, or investment bankers. When houses of this type undertake

to sell a large issue of securities, they commonly proceed to form an underwriting syndicate, composed of firms of bankers who will join the large investment banking houses in guaranteeing the sale of the securities; the underwriters are included among the retailers of securities.

Each underwriter will apply to the head of the syndicate for the right to subscribe to a certain amount of the securities to be issued. The amount of the subscription granted to them by the head of the syndicate is called their allotment. The banking house which organizes and manages the underwriting syndicate is called the syndicate manager. When a syndicate has been formed and a number of banking houses have agreed to join the syndicate manager in underwriting, or guaranteeing the sale of a security issue of a corporation, the syndicate manager may sell the securities in the market, or through the stock exchanges, and divide the profits made on the sale of the securities among the members of the syndicate, in proportion to the amount of securities allotted to each one.

As a rule an underwriting syndicate is formed for a short period of time. At the end of that period, the syndicate manager will divide the unsold securities among the members of the syndicate, who will pay the agreed price for them. It may also be agreed by the parties to the contract that the life of the syndicate shall be continued until the manager has sold all of the securities. In the meantime, however, the underwriters advance a definite amount of money to the syndicate manager to provide funds for the corporation that has sold its securities to the investment banker.

Small corporations floating loans, or selling stock through investment banks, will usually go to a retailer of securities, or a small investment banker, who will buy their issue outright or guarantee the sale of their securities and proceed to sell the securities to their clients at a reasonable margin of profit. For instance, a corporation may want to raise $100,000 additional funds through the sale of securities to the general public. An investment bank may buy the issue at $97 per bond or share of stock, and proceed to sell it to its customers at $99 per bond or share.

It has become the custom with a number of retail dealers in securities to specialize in the securities of certain kinds of enterprises. Dealers in public utility securities, dealers in real estate mortgage bonds, dealers handling securities of foreign governments, etc., are found in most large cities today. These dealers have a selected group of clients, or customers, who like to invest in these securities.

The investment banker offers investment securities suitable to the needs of various classes of investors, furnishes to investors, free of charge, accurate information on securities, receives amounts subject to check, and allows interest on daily balances, collects and remits dividends and interest, negotiates collateral loans for various classes of borrowers, executes orders for the purchase, sale, or exchange of securities on the exchanges, and in some cases carries on the business of foreign exchange. The investment business, however, remains the primary business of the investment banker, and all other business is merely incidental or subsidiary thereto.

The investment banker organizes his business on the lines of a jobbing house. He has a large number of present, prospective, and potential customers on his list. He circularizes these regularly, sending out prospectuses, following up inquiries, and issuing public advertisements.

He enjoys special advantages in the financing of his business. By the liberal employment of his credit he is able to do a large business with a comparatively small capital, an investment banker with a capital of half a million being one of rather large capital. So far as possible, he endeavors to make his purchases and sales equivalent in volume. In an active securities market it is usual for a large issue to be sold before the distributing banker has to put down his final payment for it. However, sometimes he will have to carry a block of securities in stock, and in such a case he falls back on his established lines of credit with various banks and trust companies, pledging the securities that he holds as collateral for loans, on various margins of securities that vary with the quality of the collateral offered and with the condition of the money market.

Very generally, under ordinary circumstances, the cost of selling an issue of securities is less when an investment banker is employed. The ordinary corporation has none of the equipment for selling securities. In order to sell direct to the public it will have to organize a securities sales force for the sole purpose of marketing a single issue, disbanding this expensively created organization after the issue is sold. It will have to rely on the extremely expensive method of newspaper advertising to interest prospective customers. The investment banker, on the other hand, is prepared to do at low cost what the corporation will find very costly to do. He has a permanent, highly trained selling organization and an established clientele. He will have a large number of customers who place their faith in him and will purchase securities from no one else. The investment banker can count on a certain amount of money from them at regular intervals for the purchase of securities to be offered by him.

Bankers, moreover, are not obliged to force a market for the securities they purchase. They can utilize their credit to carry stocks and bonds until a favorable opportunity arrives for marketing them. But the corporation, although it may have a good credit for its ordinary business, would have much difficulty in establishing a credit with which to finance a venture into the security business. The same banker who might look with disfavor upon a proposal to lend to a corporation on securities that it is offering direct to the public, will readily favor a proposition coming from an investment banker to lend on the same securities, purchased by him from the corporation.

There is also the fact that the investment banker can create an immediate market on favorable terms for securities for which at the outset the public demand may be weak. He will be able to exchange these new securities for seasoned securities of long standing for which a ready market exists and which have been purchased from him in the past by his regular customers. When direct sale of a new issue would be impossible, a banker may completely dispose of it in this way to his numerous contented customers. The corporation has no recourse such as this.

The banker, moreover, can estimate rather accurately what his selling costs will be. The corporation will not be able to estimate what it will cost to sell, or attempt to sell, direct. It will frequently turn the work over to some advertising agency, which will attempt to sell the securities on the basis of a certain percentage of the proceeds, but will not guarantee the results. In some cases the percentage will run as high as 40 per cent., and even then the selling may have to be discontinued before half the issue is sold because of the inability to get customers at any reasonable price. The cost will turn out to be excessive, the results uncertain, and the risks great, if the ordinary corporation attempts to market its securities direct. But when a corporation uses the investment banker the cost of the new capital to the corporation is definitely determined in the banker's contract. The money will be assured at a certain date, and on the basis of a certain and definite price per bond or share. The marketing of the issue is guaranteed and the corporation sees its immediate financial future definitely and clearly.

Investment bankers, however, will not purchase any or all kinds of securities. So, when one is approached by the promoters of a new enterprise and asked to undertake the flotation, he carefully investigates the proposal. He determines, first of all, whether the new securities offered him will be salable. Unless he can dispose of them, and at a profit, the proposal cannot interest him. He must decide, furthermore, whether the securities will be such that he can honestly recommend them to his established clientele. He aims always to cultivate the good-will of his customers, and to keep his hold on them. Without them his organization would be valueless. To hold them he must recommend for purchase only securities that represent safe investment. If by any chance he should offer securities that turn out unfortunately, he will in some cases stand ready to buy them back from his established customers, or to go to considerable expense and trouble in undertaking the reorganization of a company whose securities he has been responsible for marketing.

PROVISION OF WORKING CAPITAL

24. Definition of Working Capital.—The working, or revolving, capital of a corporation consists of the excess of the current assets over the current liabilities. By current assets is meant those assets which, in the ordinary course of business, can or will be converted into cash for purposes of operating the business, within a comparatively short period of time, usually not exceeding one year. Current liabilities are those debts or obligations which must be paid in the ordinary course of business, within a short period of time, out of the income of the business. It has become the practice of some business managers to speak of working capital as current assets, without regard to current liabilities, and to refer to the excess of current assets over current liabilities, as the net working capital. In order that there may be no misunderstanding as to the use of the term, the expressions revolving capital and working capital will here be used to mean the total current assets available for the conduct of the business.

What is the nature of these current assets? Cash is, of course, the best of all forms of current assets. Current assets also include open accounts for merchandise sold and accounts receivable which can be collected in the near future, usually within sixty days; also securities, stocks, and bonds that can be easily converted into cash without affecting the general status of the corporation. For example, a corporation may own stock in another corporation, by virtue of which it obtains a controlling interest in that corporation. To sell such stock might very definitely injure the chances of control of the second company, and such stock would commonly not be regarded as a current asset. Only those securities which are marketable, and which, when sold, do not seriously interfere with the general condition of the business, can be disposed of and be regarded as current assets. When examining the items of current assets on the financial statement of a corporation, too much importance, however, should not be attached to securities unless they are listed and are stated at their actual market value. Not infrequently business concerns will include among

their assets securities evaluated at their face or par value, even though their market value is considerably less. It is obvious that such a fictitious valuation of securities gives a wrong impression of the amount of current assets. In looking over the financial statements of corporations published in Poor and Moody's Manual of Industrials, one can find such items as "Liberty Bonds and other securities $50,000." How many of these securities actually represent Liberty Bonds and how many other securities cannot be learned from such a statement. It is therefore essential that securities should be included in cur-

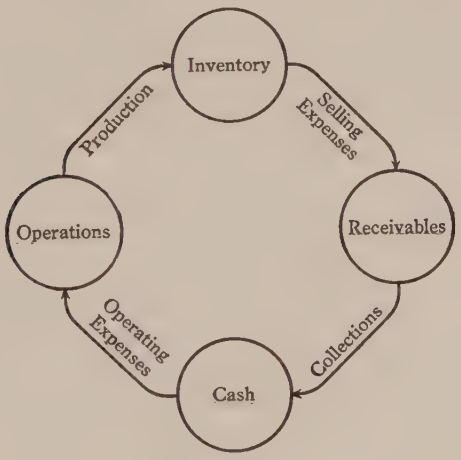

FIG. 4

rent assets at their market value, and not at their face or par value. This is equally true of stocks and bonds, for bonds also fluctuate in value.

Current liabilities consist of bills and accounts payable, as well as wages, interest, and taxes. These obligations must normally be paid, within a relatively short period of time, out of income. Wages are payable weekly or monthly, interest is usually paid twice a year, and some taxes are paid annually, others in quarterly instalments.

Since the purpose of the current assets is to provide a fund for revolving, or working, capital, which can be used to keep

the business operating, we can represent the use of these funds of working, or revolving, capital to form more capital, by a simple diagram, as in Fig. 4.

In starting a business, the cash fund from which working capital is derived is obtained primarily from the sale of the securities of the corporation. This cash fund is employed in organization to pay operating expenses, hire labor, and buy raw materials so that production may be begun. The funds thus employed will start the plant or business going. As a result of operation, inventory or finished goods will develop. This process of converting one form of goods and services into other kinds of goods is called production. The product thus obtained must next be sold and delivered. Out of these sales arise accounts and bills receivable. When these are paid or collected, they provide a fund that will flow back into the cash fund, thus making possible the continuance of operation.

The importance of keeping this revolving fund, or working capital, moving continually, becomes clear from our diagram. If the funds of working capital in the cash drawer or the bank account are not sufficient to hire labor, buy raw materials, and pay operating expenses in general, the operation of the industry must stop. Without operation there is no inventory; without inventory there is nothing to sell, and without sales there is no income from the business.

On the other hand, if the process stops with production, funds may be expended for operation, finished product will pile up, and the industry would soon find, even though it is producing stock, that it cannot continue, for it cannot move this stock. Finally, even though goods are produced and sold, unless the buyers pay their bills, it is clear that the business cannot continue very long. It is, therefore, necessary to keep the four stages in the process of converting cash into more cash, moving steadily and smoothly. Unless this is done, earnings from operation will vary considerably, labor will be irregularly employed, and higher prices will have to be paid for materials because of the necessity of buying in smaller quantities, owing to the uncertainty of operation.

25. Sources of Working Capital.—Although the chief source of working capital in any business is a regular income from operating the business, every business man knows that these funds of working capital are not always large enough to meet all requirements. The extent to which he will have to search for other sources of working capital to build up his cash fund will depend largely on the rate of turnover of finished product in his particular business. If, for example, his outstanding bills receivable are short-time obligations, and these receivables are paid, let us say, in one month, it is clear that the funds thus obtained would be larger than if the bills were paid every 3 months. In order to induce prompt payment of receivables, business men usually allow a discount for cash. Any payment made within 10 days after the receipt of the bill, is commonly regarded as a cash transaction. In this manner, business houses keep a steady flow of cash turnover for working capital. If the flow of this cash is very regular, it is not necessary to build up a large fund of working capital at any one time. For example, if a business man needs $1,000 a day for working capital, and his cash sales from day to day amount from $1,200 to $1,500, he would normally need a fund for working capital of $1,200 to $1,500, which would leave him a safe enough margin. On the other hand, if the business man would require $1,000 a day to be paid for materials, selling expenses, labor costs, etc., and he received payment from customers only once every month, he would need a fund of working capital of at least $30,000 with which to operate. The working capital needed by a street railway company, whose business is cash, or by the cash grocer, is considerably less than the working capital required by business houses carrying on their business on credits of 30, 60, or 90 days.

If, therefore, an enterprise cannot get enough of its working capital from the regular receipts from business operations, what are some of the other sources of working capital? It is sometimes possible to replenish working capital by special cash sales. This means of providing additional working capital from customers is very often employed by department stores, to move slow-selling merchandise, or bargain merchandise.

Furthermore, a business house that has established itself as a reliable concern can usually buy its raw materials and intermediate products needed for manufacture on credit. If the credit thus obtained is long enough, the manufacturer or merchant may sell the product thus bought and used for manufacture, or used for stocking up the merchandise establishment, and receive the payment before he must pay his trade creditors. Commission houses usually operate on this basis, and therefore require very little working capital. They will receive goods from their trade customers and proceed to sell, making payment for the goods only after they have received payment and deducted their commission. Farmers, as a rule, do not have a large fund of working capital, but commonly obtain credits of from 3 to 6 months, or, perhaps, longer, from the dealers in seeds, farm implements, and fertilizers, etc., and pay off their debts with the proceeds from the sale of their crops.

But not all kinds of enterprises can make use of such trade credits. This is true particularly of new or young business ventures, which have not yet established their earning power. It is for this reason that the new enterprise usually provides in the beginning for a larger amount of working capital than an established enterprise in the same line, transacting about the same volume of business.

It has been indicated that a certain amount of working capital is provided by the sale of corporate securities; either stocks, bonds, or short-term notes. Sometimes a corporation will be formed and capitalized for a certain amount, but not all of the capital will be issued at one time; and that which is issued will be made assessable. In other words, the subscribers to such stock will pay only a small percentage of the face or par value of the stock, and the remainder will be subject to call at any time, when, in the opinion of the board of directors, it is needed for the conduct of the business. Such assessable stock may provide a source of working capital for a business that cannot replenish its revolving fund either with operating receipts, with credits from its customers, or with long-term credits.

In addition to the foregoing methods of providing working capital, commercial banks are the main source of working capital. A most important function of a bank is to meet cash requirements for business operations. In many concerns, the cash requirements will fluctuate, within rather wide limits, in the course of a year, because of the seasonal nature of production and of sales. The sale of agricultural machinery and fertilizer, for example, is highly seasonal. In spite of all efforts to assure stability of earnings from month to month, the receipts of a large number of industries and business houses vary widely. An ice company will find its earnings decidedly less in winter than in summer and the opposite is true of a coal dealer. That is why, in many cases, the coal business and the ice business are conducted by the same company.

In order, therefore, to tide such industries over periods when business in their particular line is dull and collections are lagging, their managers must borrow a portion of their working capital from commercial banks, and thus keep their plants operating steadily. It is one of the characteristics of present-day business organization, that production is carried on well in advance of sales. Business houses buy raw material at one time, and sell their finished product some months later. The iron ore for the 1925 steel production, for example, was largely accumulated in 1924. Thus, there is, in addition to seasonal fluctuations, a lapse of time, in practically every business, between the dates of buying the materials and selling the finished products. Here again, the commercial bank provides the funds with which to buy materials and to tide over the business until receipts from sales come in.

Commercial banks will loan funds to their trade customers in a number of ways. Sometimes a person who has an established reputation with his bank can borrow from the bank by simply giving his promissory note. Such a promissory note, signed by the person who borrows the funds, is called a single-name paper. If a second party assures the bank, by writing his name on the back of the note, that the borrower will repay his obligation and that, in case he does not, the second party will do so, such a note is called a two-name paper.

Banks, however, do not like to loan their funds merely on promises to pay without any security to support the promises. They prefer to have some evidence of paying ability which is more tangible, more concrete. In order to meet such requirements of the commercial banks, the custom has arisen of borrowing from the banks on such instruments as warehouse receipts certifying to the possession of salable merchandise, or stock and bond collateral. When stocks and bonds are pledged as security for a loan the borrower gives the bank the power, in writing, to sell such securities if he, the borrower, should fail to meet his obligation when due. But the bank can recover only the amount due on the loan, when it sells the collateral. Any surplus over this amount, realized on the sale of securities, must be returned to the borrower. As a rule, commercial banks will not resort to the sale of collateral pledged as security, until they have given the borrower every opportunity to pay his debt. In periods of business depression, in particular, it is not advisable for banks to sell securities in order to collect the amount due them. Such a policy, if pursued by many banks, would suddenly throw a large number of securities on the market and force down their price to a point where the proceeds would not even suffice to cover the amount of their loans. Again, banks will loan funds on the open accounts of customers of the business man. For example, John Jones has a bill of goods which he has sold to Henry Brown, and Henry Brown has agreed to pay for these goods, within, let us say, 30 days. This account receivable of Henry Brown can be transferred by John Jones to his bank, to whom Brown is ordered to pay.

26. Trade Acceptances.—A trade acceptance is simply a draft or bill of exchange drawn by the seller on the purchaser of the goods sold, and unconditionally accepted in writing upon its face by the purchaser. In accordance with the standard form which has been generally adopted, the acceptance has printed on its face the statement that: *The obligation of the acceptor hereof arises out of the purchase of goods from the drawer. The acceptor may make this acceptance payable at*

any bank, banker, or trust company in the United States which he may designate. The acceptance may be made payable, by the acceptor, at his own place of business, but ordinarily, for convenience's sake, it will be made payable at the customer's own bank. Across the face of the draft are dotted lines for the signature of the acceptor, the date, and the designation of the bank or other place of payment, to be filled in by the acceptor.

In this manner a large amount of so-called commercial paper, promissory notes, bills of exchange, drafts, trade acceptances, and the like, are bought and sold to provide funds for working capital. When a bank buys such a paper from a customer it will usually not pay its cash for the promise, but will give him credit on his account, against which deposit the customer can draw his checks. In this way, the banks create deposits for their customers, not merely by the cash that is paid to the receiving teller, but also by means of loans and discounts.

27. Loans.—Loans usually consist of an exchange of bank credit for personal credit. When a definite amount is loaned to the customer by the commercial bank, for, say 3 months, and at the end of 3 months the customer repays that amount plus the interest for that period of time, we say he has met an interest-bearing loan. The interest is not paid until the loan falls due. On the other hand, if the customer discounts a note, it is the same as making the loan by having the rate of interest subtracted from the face value of the loan at the time it is made. The customer repays the full amount actually borrowed plus the discount. Thus, for example, if a person borrows $2,500 from a commercial bank at 6 per cent. for 6 months, he would receive $2,500 when he made the loan, and at the end of 6 months, pay back $2,500 plus $75, or 6 months' interest at 6 per cent. per annum. On the other hand, if he had a note for $2,500 discounted at 6 per cent. for 6 months, he would receive $2,500, less $75 when he made the loan, and pay back $2,500 6 months hence. In the one case the customer has the use of $75 interest for 6 months, and in the other case the bank has the use of $75, or 6 months'

interest. Commercial banks, as a rule, prefer to discount their loans, rather than collect the interest when the loans fall due.

In addition to commercial banks, whether National, State, or Private Banks, a number of so-called commercial-paper houses, or commercial-credit houses have developed to furnish industries with working capital. When, for example, a concern is so large that it cannot borrow the required amount for working capital in its own locality from the commercial banks, it will often sell its promissory notes to a note broker, who, in turn, will resell the notes to a large number of banks. These notes are drawn up to the borrower's order, and endorsed by him, after which they can be sold to any one.

28. Selling Accounts Receivable.—Many business organizations, usually relatively small companies, however, the majority having a net worth of less than $100,000, will sell their accounts receivable to, or borrow on these accounts from, commercial-credit houses. These credit houses advance the company usually from 75 to 80 per cent. of the face value of the accounts. Sometimes the commercial-credit house will even act as guarantor of the accounts of the client; in such cases the credit house checks the credit before the order for goods is accepted. Accounts are bought on either the notification or non-notification plan. If the former plan is used, the debtors of the merchant are notified that their accounts have been assigned and that they are to pay directly to the commercial-credit house. The purpose of this plan is to protect the credit house from collection and fraudulent appropriation by the merchant. Most frequently the second plan is used, in which the debtor is not notified; the account is collected by the original creditor, the merchant, and the proceeds turned over to the credit house. Customers dislike the notification plan; they suspect the merchant who uses it of being financially weak and unreliable, and they do not like their own delinquency, if they are delinquent, to be brought to the attention of outside parties and their own credit therefore jeopardized. The credit house has as security for its advances and charges, first, the debt owing from the customer to the merchant; second, the

general liability of the merchant; and in some cases a personal guarantee from the officers of the merchant company or from some other person, such as, for example, some manufacturer who does a large business with the merchant.

This plan of getting or maintaining working capital is used for various reasons. Many firms, for example, are more experienced in the practical manufacturing and selling part of their business than in finance, and dislike to borrow heavily from banks, with which they will not carry substantial balances. Many lines of business also sell on from 6 to 12 months' credit, evidenced by notes, payable in instalments, and thereby quickly tie up their operating capital, and must find a continuous outlet for such paper. Such firms regard a credit company as a silent partner with elastic resources.

The above sources of working capital are available, to a greater or lesser degree, to every successful concern. The wide-awake financial manager will always be on the lookout to use sources of working capital that will give him the least trouble. He will play off one kind of credit house against another, one buyer of commercial paper against another and in this way obtain his funds at the least cost. There is no excuse for continually paying a higher price for loans and discounts, simply because a person has been dealing with a certain bank for a long period of time. Usually bankers know that alert business men are in the market to buy as cheaply as possible, and will give preference in rates, as well as in general terms, for repayment to their established clients.

It is thus seen that there are a great many sources of working capital available. In general, however, it is safe to assert that the chief and basic source of working capital should be the regular receipts from operating the business.

Any business that does not pay careful attention to the collection of its accounts but relies on other sources of credit to tide it over will, sooner or later, find itself in trouble. Buyers from such a concern will soon realize that the business with which they are dealing is not very alert in collecting its bills, and will, therefore, postpone payment as long as possible. A large amount of outstanding receivables may sometimes indi-

cate a healthy condition of business, but at other times, it may actually mean financial ruin. If the receivables are collected regularly, they will assure a steady flow of receipts to replenish the cash fund of working capital. If, on the other hand, they are allowed to pile up, and a period of business depression should set in, the business house with large accounts receivable outstanding may find itself compelled to write off a goodly percentage of these accounts as uncollectible or bad debts, and, as a result, find itself in financial difficulties. Commercial banks and commercial-credit houses should be resorted to on the part of business concerns, not to finance their regular, but rather their irregular, requirements for working capital.

DETERMINATION OF CORPORATE PROFITS

29. Sources of Income.—Corporate income is derived from three main sources: (1) income from operations; (2) income from outside activities; (3) income from investments.

Operating income is the income a company receives from carrying on its principal business. The total receipts of the business derived from the sale of its products or its services, over a period of time, are called its gross operating income.

Every successfully operated enterprise is anxious to have a steady flow of gross income. Such a stable gross income from the operation of business means the steady employment of labor, continued industrial activity, greater possibility of borrowing money, regular dividends, and more or less steady prices. Every careful business manager should, therefore, strive to realize a steady flow of gross income from his business.

But not all concerns can have such a steady flow of income, either from year to year, or at different times during the same year. There are many so-called seasonal businesses whose volume of trade changes from time to time. For example, gas and street railway companies at a seashore summer resort find their earnings fluctuating very considerably between the summer and winter months. There are many types of industries, however, that can increase their regular flow of revenue (1) by pushing sales during so-called dull periods; (2) by

producing, far in advance, on order; and (3) by manufacturing different lines of similar products from the same raw materials.

Every ambitious manager will strive to have his sales distributed, as nearly as possible, uniformly throughout the entire year. When the equipment stands idle, when stocks or inventory on the shelves are not moved, it means a loss to the business. If, therefore, such equipment can be used or such goods can be moved, the careful business manager should make every effort to do so. With this object in view, the managers of electric companies furnish electric power for the use of factories, at a fairly low rate during the day, and provide electric light to the city at night, thus making possible the continuous use of their equipment in order to realize a steady flow of income. Telephone and telegraph companies offer reduced rates for night service in order to employ their equipment in times when, without those reduced rates, it would be idle, and by thus using it keep up an even flow of revenue. Railroads run summer excursions, at reduced rates, to induce people to travel who might otherwise stay at home. Department stores advertise reduction sales and bargain sales after the Christmas holidays, in order to attract customers, and thus supplement their revenues, which would otherwise be far below the receipts during the months before the holidays.

In order to arrive at net profits, or net earnings, from operation, the necessary expenses of operation must be subtracted from the gross operating income. The Federal Trade Commission of the United States has made an exhaustive study of a large number of businesses, and in a document entitled *Fundamentals of a Cost System for Manufacturers* has published a careful analysis of manufacturing expenses. It divides expenses into three general groups: material, labor, and overhead expenses. Some of these expenses are variable, such as the cost of actual raw materials used in the manufacturing of each unit of a product, as well as the cost of labor employed in the making of a product. Others are fixed, such as the charges for property, taxes, insurance, interest, and replacement expenses. These constitute general overhead expenses

that must be met, regardless of the volume of business transacted.

Studies have been made of the part of gross revenue consumed by operating expenses, both fixed and variable, to determine how much gross revenue is necessary for different kinds of businesses, after deducting operating revenues, to yield a fair return on the capital funds invested in the business. In the field of public utilities, the general rule is that there must be $1 of gross revenue for every $5 of investment. In other businesses, this ratio of gross revenue to investment varies. No general rule can be made which would apply to all enterprises.

Every financial manager should make a thorough analysis of the ratio of the gross business transacted, as reflected in gross operating revenue, to total investment in this business, over a number of years, and should compare these ratios or relationships with the same ratio of competing companies. Wherever this study is made with the proper amount of care, it will show whether the company's gross revenue is large enough to support the fixed capital, or whether the company's fixed assets are too large in relation to the amount of business transacted.

The problem of keeping down variable expenses is one that is ultimately connected with careful buying of materials, as well as with efficient use of such materials and with labor. The general principles that should guide the financial manager in providing the necessary funds to begin to operate an enterprise have been indicated. When, however, the enterprise is an established concern, and is operating to capacity, with a well-organized plant and efficient labor, the next problem confronting the financial manager is to determine the amount to be set aside out of gross revenue, for depreciation of property.

30. Depreciation.—Depreciation of property may be defined as loss in property value. It differs from deterioration, which is loss of property by the wearing out of material objects. We say, for instance, a property has depreciated 10 per cent. in the course of a year, meaning by that, that it

has lost 10 per cent. of its value during the period. Thus a property valued at $100,000, depreciating 10 per cent. in a year, would be worth only $90,000 at the end of the year. On the other hand, a property has deteriorated when it is no longer as useful as it was before, as, for example, a building when it needs a new roof, or an engine when it needs a new governor.

Depreciation and deterioration are not, necessarily, the same. The difference between the two can be illustrated in the case of the automobile. A person buys a new car and drives it out on the street. As a result of this move, the car has depreciated. It is no longer regarded in selling circles as a new car, and if the buyer wanted to sell it immediately afterward, he would find that he must sell it at a loss equal, at least, to the amount of the commission received by the agent who sold him the car. It would be a second-hand car. On the other hand, the automobile, in changing owners, would not, necessarily, have deteriorated. As a matter of fact, any one who has driven a new automobile knows that for a time it improves with use, that it has to be "broken in," that it does not reach its maximum efficiency until it has run at least 1,000 miles. Up to this point, depreciation has been fairly large; deterioration, on the other hand, save for tires and upholstery, is not apparent. In speaking of depreciation, therefore, one should have clearly in mind the loss in property value.

The present value of an article is the difference between its original cost value and the depreciation. There are many causes of depreciation, or loss in the value of an asset. Among them are, the ordinary action of nature, the effects of the elements, such as rain, snow, hail, excessive heat of the sun, and the like. Second, there is wear and tear due to the use of the property. In these two causes, depreciation can be foreseen with a fair degree of accuracy. Suitable reservations can, therefore, be set up out of gross earnings of a corporation to replace the loss resulting from these causes.

On the other hand, there are certain causes of depreciation which cannot be foreseen, due to obsolescence, or going out of date. A new machine is invented and the old machine is out of date. It is obsolete, even though it may have been

installed in the factory only very recently. A new, cheap process of manufacturing is discovered and existing equipment must be scrapped. Again, there is the possibility of loss or depreciation due to the loss of usefulness of property. A change in the demand for the article may change the usefulness of the machine that has been making that article. A machine may be still as good as new but the product which it has aided in making is no longer wanted. The taste of individuals may change from time to time. Sometimes the government will pass laws intended to change the nature, or the amount, of different goods consumed. At the close of the World War in 1918, any number of industries in this country found their plants equipped with much new, expensive machinery to be used in the manufacture of war implements. Some of this machinery could be put to other uses, but a great deal of it was of such a highly specialized nature that it could be used for only one purpose. A Harrisburg company, by way of illustration, had a large storeroom full of delicate machinery intended to be used in the manufacture of shells, which had only scrap value after the war, although the machinery was practically new. Hundreds of industries throughout the country found themselves in the same predicament after the war.

Finally, changes in prices of materials may result in property losses. If a person has equipped his plant with, for example, laundry machinery, and similar machinery is sold shortly afterwards to a competitor at a decidedly lower price, the owner of the high-priced equipment will be at a disadvantage, and may have to suffer a loss because of the interest and depreciation charges on the high cost of his machinery. Moreover, the change in the general level of prices may affect a business so that the selling price that a manufacturer or business man can realize on his product will not cover his production cost.

It is thus seen that there are many causes for loss of property values. It can be offset, in part, by taking the best possible care of the present property. Thus, for example, considerable loss may be avoided on machinery and equipment by proper housing, oiling, and repairing. But even when the

very best care is taken of it, equipment will eventually wear out. Provision becomes necessary for its replacement. This is done by setting aside reserves, out of income, to replace depreciated property. It is impossible to say just how much is an adequate reserve for a particular industry or a particular kind of machine or equipment. Different kinds of machinery, equipment, and buildings wear out at different rates, because of the many causes previously cited. It thus becomes necessary to study carefully the effects of depreciation upon different classes of property. In order to provide a fund that will be adequate to replace that which is destroyed, the life of each capital asset must be carefully estimated.

31. Appraisals.—In comparatively recent years a number of firms have been established in the United States for the purpose of making careful studies of costs, of materials, and rates of depreciation, with a view to arriving at an accurate valuation of business properties. In the course of their experience, such appraisal companies have gathered much valuable information regarding the rates of depreciation of different kinds of business property. The services of such companies can be enlisted by the business man who wants to obtain an idea of the present value of his assets and their rate of depreciation, based on careful analysis and observation. Such information is invaluable in determining the amounts of insurance a business should carry, the allowance that should be made for depreciation of different kinds of assets, and the value of such assets as a basis for a possible loan.

32. Reserves.—There are many ways of setting up reserves for depreciation which are applicable to different kinds of assets. In the first place, the same amount may be set aside out of earnings each year to allow for depreciation. Thus, a machine that will probably have to be replaced after 10 years by a new machine, may depreciate by, let us say, 10 per cent. of its value each year. This method of depreciation of property is spoken of as the straight-line method of depreciation.

Again, proceeding on the assumption that the machine wears

out more rapidly after it has been used a while than when it was first installed, some financial managers provide for an increased amount to be set aside each year, out of earnings, as a depreciation reserve. This method of depreciating assets has the advantage of increasing the amount of fixed charges on the earnings of a corporation, as the corporation increases its earning capacity from year to year.

In some cases, it may be found advisable to reverse this order to set up a large reserve for depreciation at the start, decreasing it from year to year as the maintenance charges increase. In other words, the amount necessary to maintain or to keep the machine operating when it is new is, ordinarily, smaller than the amount required to keep it in a normal state of repair after it has been used for a period of time. Therefore, some concerns provide, or use, a larger amount, from year to year, for maintenance, and establish a smaller fund annually for depreciation. In this way the total charges each year for depreciation and maintenance will be more or less constant, and follow the straight-line method illustrated above.

Finally, since one of the chief causes of depreciation is wear and tear due to the use of equipment, the more intensively and extensively the equipment is used the larger the possible product, and as a result, the larger the possible net earnings. On this principle some companies, in making up their depreciation reserves, take a certain percentage of the earnings derived from operation each year. If their earnings are large, it is assumed that the equipment will have been used harder than if the earnings are small. Therefore, they contend a larger amount should be set aside for depreciation under such conditions.

Whatever method may be employed, it should be the duty of every financial manager to set up adequate reserves out of earnings to replace assets as their value declines. Only by making such adequate reserves can the value of an investment be safeguarded. If this is not done, it will be soon found impossible to borrow funds at such low rates as at present. If people or institutional investors have to take larger risks with their investments, they will want a larger possibility of

reward. That, in turn, will mean higher fixed charges, and these will, in turn, be reflected in higher production costs. Thus the provision of adequate reserves based on careful study and observation is of significance not only to the financial manager of an enterprise, or to the investor in its securities, but also to the consuming public, which, because of the greater risks of the investor, would have to pay higher prices if the costs of these products were increased.

33. Operating Income.—When total fixed charges and variable expenses have been deducted from gross operating revenue, the difference will represent the net operating income. To this amount, the income derived from activities of the corporation in other business transactions, such as selling of corporate securities at a premium and selling corporate investments at a profit, must be added. This often forms a goodly source of supplementary income in large businesses. Finally, corporations often have invested funds held for reserves of different kinds—depreciation reserves, or perhaps reserves for insurance and taxes—and the income from these investments yields an additional revenue. The income statement of a typical business enterprise may thus be set up as follows:

Gross operating revenue	$1,000,000
Loss, fixed charges, and variable operating expenses	800,000
Net operating revenue	200,000
Less depreciation and other reserves	100,000
Net income from operating business	100,000
Plus income from other activities (net)	20,000
Plus income from investments	10,000
Total net income	$ 130,000

FINANCE AND INVESTMENT

(PART 3)

Serial 2253C Edition 1

EXAMINATION QUESTIONS

Notice to Students.—*Study the Instruction Paper thoroughly before you attempt to answer these questions.* **Read each question carefully and be sure you understand it;** *then write the best answer you can. When your answers are completed, examine them closely and correct all the errors you can find; then mail your work to us.*

(1) Define capitalization.

(2) (*a*) What are mortgage bonds? (*b*) How are they used by corporations?

(3) How do collateral trust mortgages differ from other mortgages?

(4) In a general way, what is the difference between investors and speculators?

(5) (*a*) What are Blue Sky laws? (*b*) What is their object?

(6) (*a*) With respect to additional stock issues, what are stockholders' subscription rights? (*b*) How is the value of these rights ascertained?

(7) Discuss employe and customer stockholders from the viewpoint of a corporation.

(8) Name a few classes of security dealers, and briefly discuss each.

(9) (*a*) What is working capital? (*b*) What are the sources of it?

(10) What are trade acceptances?

Mail your work on this lesson as soon as you have finished it and looked it over carefully. DO NOT HOLD IT until another lesson is ready.

FINANCE AND INVESTMENT
(PART 4)

DISTRIBUTION OF EARNINGS

DIVIDENDS AND RESERVES

DIVIDENDS

1. Distributions of profits by corporations to the stockholders are commonly referred to as dividends. This distribution is, or should be, made by drawing upon an existing surplus. Under any condition, dividends give way to interest payments, the latter being a fixed charge and payable at all events, while a dividend is payable only if earned. The law does not permit the declaration and payment of dividends if the capital of a corporation is impaired. This means that a surplus should appear on the balance sheet of the corporation in order that it may lawfully declare dividends. Under the laws of some states, it is not technically necessary that a surplus must appear to enable a corporation to pay dividends, if a distribution can be traced and earmarked as having been derived from earnings. Paying dividends under such circumstances, however, is subject to criticism as poor business policy, to say the least. In any case, in properly conducted businesses, an existing deficit should be wiped out before dividends are declared.

An exception to this rule exists where so-called liquidating dividends are declared and paid to stockholders. These are a return of capital to stockholders in their respective proportions,

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and priorities, if any, upon dissolution of the corporation, or upon decrease of outstanding stock. They cannot properly be declared in either case if, by so doing, the capital returned to stockholders will prejudice the rights of corporate creditors. Liquidating dividends are sometimes paid also in cases in which directors mistakenly calculate that they are distributing earnings, but are actually distributing capital. Such distributions are illegal, in the sense previously named, but if there are no objecting creditors, the distribution may, and often does, remain undisturbed in the hands of stockholders.

2. Dividends can be declared only by the directors of a corporation. Stockholders, at their meetings, sometimes attempt to declare dividends. Their action in this respect is merely a request or suggestion that the directors take appropriate action toward this end. Occasionally, as we shall find hereafter, the courts will, in proper cases, order the declaration of a dividend. This means that a peremptory order is given the directors to take the necessary steps to declare and pay a dividend. Until dividends have been declared, the profits and surplus belong to the corporation. When dividends have been declared by the directors, and the stockholders have been notified, a separate fund is created and set aside for the benefit of the stockholders. When a separate fund is so created, the corporation and the stockholders entitled to the dividend are in a debtor and creditor relation. In such case, if the dividend has been properly declared, the stockholders can sue the corporation as to such dividend, and in event of subsequent insolvency compete with other creditors. Stockholders may even insist on the payment of the dividend set apart, if a subsequent casualty occurs, such as a fire loss wiping out corporate assest and rendering the corporation incapable of transacting business without fresh capital.

Occasionally a board may declare dividends that subsequent events prove to be ill-advised. If the dividend has been declared and set aside, and stockholders have been notified, it is too late for the board to reconsider its action, unless the stockholders will voluntarily relinquish their claim. If, however,

a dividend is declared but not set aside, and stockholders are not notified, the board may rescind its action and the declaration will become of no effect. In cases in which a dividend is declared and there is no surplus to charge, the board may rescind its action even if stockholders are notified. It has also been held that the declaration of a stock dividend may be rescinded any time before delivery of the stock certificates, regardless of whether or not the stockholders have been notified.

The method of procedure in declaring dividends is as follows: At a meeting of the board of directors, the financial status of the corporation is examined. If the directors find that profits are available for dividends, they may set apart some of these profits and label this segregated fund "Dividend fund." Next they will decide on the rate of dividend or the amount of dividend to be paid on each share of stock outstanding, and, finally, they will give notice of their action to the stockholders, sometimes publishing in a newspaper the fact that a dividend has been declared.

SURPLUS AND RESERVES

3. Caution in Declaring Dividends.—When contemplating a dividend, the directors should exercise extreme caution before committing themselves to a dividend declaration. It is their duty to analyze the statement of assets and liabilities to establish to a certainty that a bona fide surplus exists against which to charge the dividend. Upon a critical examination of the balance sheet it may appear that the various items are overvalued or undervalued. If such conditions exist, proper adjustments should be made before a dividend is declared. If a balance sheet shows no surplus, occasionally values may, in proper cases, be written up on the books to the extent of the actual appreciation. It is generally considered inadvisable, if not illegal, to write up good-will to create a surplus to be made the basis of a dividend payment. Notwithstanding this, the practice has been recommended by eminent authority. It is, of course, not objectionable to capitalize good-will when it has been acquired for a consideration or capital outlay; otherwise its legality is open to serious question. In proper cases, it is lawful to write up

the value of tangible property to create a surplus for dividend purposes. Thus a corporation may have acquired a piece of real estate in the outskirts of a city at a cost of $100,000. The growth of the city might easily be such that the value of the particular property might be increased, say, conservatively, to $500,000. The $400,000 increase may be added to assets, of course, taking into consideration depreciation, if any, sustained in the meantime; however, a conservative business man will not ordinarily build up a surplus in this manner, nor will he utilize such surplus for dividend purposes.

4. Reducing Stock to Create Surplus.—Another method by which a deficit may be wiped out and a surplus created is to reduce outstanding stock. This may be accomplished in numerous ways, the most advisable being a charter amendment reducing the authorized capital stock. If a portion of the authorized stock is reduced and stock called in, in pursuance of the amendment for retirement and cancelation, the capital stock is reduced to the extent of the stock which is called in. If the stock has a par value, this is the amount of the reduction. If it has no par value, the per share capitalization is the reduction. It must not be assumed that capital stock may be reduced, however, and a deficit eliminated by calling in stock for retirement when, by doing so, a dividend from a resulting surplus will take funds from creditors. State laws prohibit charter amendments for reducing capital stock, unless provision is made to protect claims of creditors.

5. Determining Whether Surplus Exists.—In determining whether or not a surplus exists, corporate officers should take depreciation into account. Property of most kinds used in business deteriorates physically owing to wear and tear, and gradually approaches a point where it is no longer useful to the business. The deterioration is generally gradual and unobserved, and is not the physical defects occurring from time to time which repairs and additions will make good. Well-managed businesses set aside a fund to replace such property. This fund may be carried as a reserve on the credit side as a subdivision

of surplus or on the debit side as a deduction from the book value of the asset. In either case, surplus available for dividends is reduced. In fact, the essential idea of the plan is to retain assets in the business to replace worn-out property rather than to pay out such funds in dividends to the ultimate disadvantage of the business, when it is necessary to have ready funds to replace the worn-out property.

Strange as it may seem, the courts have ruled that although setting up depreciation is advisable from the management viewpoint, it is not legally required that the directors shall do so in determining whether or not the corporation has an available surplus from which to pay dividends. In one extreme case, a court so ruled where the corporation was engaged in a business in which the assets were so-called "wasting assets" and no provision was made for replacement of the capital assets exhausted by the operation of the business.

Other reserves may also be advisable, such as a reserve for bad debts. Most businesses carrying open accounts experience a certain percentage of loss due to uncollectible accounts. Past experience will often demonstrate what percentage of gross sales, on the average, will not be collected; provision should be made to cover this. Sometimes a reserve is carried for the purpose, or sometimes the management will prefer to charge off these accounts, when it has been demonstrated that specific accounts are uncollectible.

In some cases, inventory valuations may call for readjustment. Thus, during the World War, many large houses stocked up with goods at high prices. In 1919 and 1920, in many instances, these values declined by wide margins, in some cases 50 per cent. or more. Readjustment and writing down these values became imperative, and existing surplus accounts were proportionately reduced. Oftentimes, also, obsolete or unsalable goods are carried in inventory at cost or other unwarranted values. In any case, consideration should be given the subject, otherwise a false surplus may be shown on the books.

6. Subdivision of Surplus to Form Reserves.—Directors may also subdivide surplus and to that extent remove it from

the reach of stockholders by creating sinking funds of various kinds, such as a fund to amortize a mortgage, to issue preferred stock, or to replace property exhausted through operation.

A favorite method of inflating assets is to increase the valuation of good-will, patents, trade-marks, formulas, and the like. Usually no one is deceived by carrying these items at high figures, except perhaps the company itself. Bankers, as a rule, utterly disregard these figures for loan purposes. If these items are carried at high valuations by the management and reflect a surplus, the board should hesitate to use the surplus for dividend purposes unless the valuations are well supported by sound values. Usually such items should be carried at not greater than actual cost, and in conservative companies they are generally carried at a nominal figure. The Victor Talking Machine Company has, for a number of years, carried its enormously valuable patent rights and good-will at one dollar.

It is customary also for corporations to carry reserves to pay accrued taxes and assets belonging to pension and welfare funds.

A well-known reserve in larger corporations is a dividend reserve. This fund is set up to insure the payment of regular dividends year in and year out, so that there shall be available liquid funds to pay regular dividends when in lean years there are no current earnings for the purpose. Such a fund is sometimes appropriately called a fund to equalize dividends. It has been said that the United States Steel Corporation established a well-planned dividend reserve fund, during the World War, by investing in a diversified list of high-grade securities, the income from which, during periods of depression in the steel trade, or any one trade, would reasonably assure dividends to the United States Steel stockholders.

Some organizations carry their own insurance risks, preferring to retain insurance premiums and build up their own fund for the purpose. In corporations having widely scattered properties the plan is often proved a good one, particularly when no losses have occurred in the early years while the fund is being built up. The premiums that would be paid insurance companies are, however, usually inadequate for this purpose, as there are no contributions by others to average the losses.

It must be remembered that reserves of various kinds are merely subdivisions of surplus, and that it is not obligatory to label them for the various purposes for which they are intended, unless the management is so inclined, or has agreed to do so, as is sometimes the case in sinking-fund reserves. In some corporations, no attempt is made to separate the surplus in this manner, the excess of assets over liabilities being carried merely as "surplus." It is recommended in large corporations, where a surplus may appear abnormally large, to make proper subdivisions to indicate the good faith of the management in withholding such funds from stockholders which, otherwise, may appear as being improperly withheld. The stockholders themselves may question the practice, or it may appear to Federal Income Tax authorities that dividends are withheld to enable stockholders to evade surtaxes that would follow the receipt of cash dividends. In such case the corporation may be taxed heavily on its taxable net income for the year in question. A subdivision of surplus which indicates that the fund in reserve is set aside for proper needs of the business may obviate any question in this respect.

It has been held by the Pennsylvania courts that a board of directors in paying dividends, cannot rely on the statements of the corporate treasurer where an inspection and examination would have revealed an inflated inventory, and in such case, it is no excuse that the directors were not informed upon the subject and could not have recognized the discrepancy upon such examination. Thus, in the light of this rigorous doctrine, every item of assets must be supported by competent appraisals and valuations, and every item of liability must reflect actual conditions. In the cases cited, the directors guilty of paying the illegal dividend were held personally liable, to the extent of the dividend payment, upon suit by a receiver.

7. In event that the corporation possesses a surplus, and dividends are contemplated by the board, many elements regarding the corporation and its future should be considered. In the case of a new corporation, the business should not be committed to extensive dividend payments, even though fully earned, until

the management has built up a substantial surplus for working capital or contingencies, and has a definite policy as to future expansion. It has been said to be poor business to commit the management even to cumulative dividends in its early years, if dividend payments will prevent a surplus from being established. No less a leading industry than the United States Steel Corporation erred in this respect by starting at too early a period to pay dividends upon its common stock, the result being embarrassment to the management subsequently and a suspension of dividends in later years, which were not resumed until a substantial surplus had been created.

Any business will ordinarily experience lean years, and periods of depression which must be financed. A prosperous business may be seriously affected by a tariff change, by labor troubles, by unsettled conditions during and succeeding a national calamity, such as the World War, and other contingencies innumerable. Against these a surplus should be established and maintained.

8. Apportioning Profits.—A dividend declared is usually at a certain rate, or per cent. on the par value of the shares of stock. Since it is common, on the part of well-managed corporations, to declare dividends at regular intervals, usually every 3 or 6 months, these dividends will be expressed as a $1\frac{1}{2}$ per cent., 2 per cent., or $2\frac{1}{2}$ per cent. regular quarterly dividend, as the case may be. If the shares of stock are without par value, the dividend will be expressed in terms of a certain amount, fifty cents, one dollar, or one dollar and fifty cents, on each share of stock.

Dividend checks will be mailed to the persons whose names appear on the books of the corporation at the close of business on a certain date, as stated in the notice given by the board of directors. This date is commonly set 2 or 3 weeks in advance of the date when the dividends are actually to be paid to the stockholders. The time between the date of the closing of the books for dividends and the date of actual payment of these dividends gives an opportunity to balance the stock ledger, and make up the list of stockholders to whom the checks are to be mailed.

When the stock books are closed for the purpose of declaring a dividend, it is not obligatory to stop making transfers. In fact, transfers can and are now customarily made at such times, but the closing date definitely fixes the list of stockholders entitled to dividends. In the meantime sales and transfers are ex dividend; that is, stockholders of record on the closing date will receive the dividend checks. If subsequent transferees are to receive dividends, they have the right to them only by special contract to that effect with their transferors.

Cash dividends are not apportioned, and therefore belong to the stockholders of record at a specified date, regardless of when they were earned by the corporation. If stock is pledged, dividends belong to the pledger in the absence of an agreement to the contrary. The corporation, at any rate, recognizes the pledger as long as he remains the stockholder of record. As between life tenant and remainderman, when stock is held in trust, the corporation, of course, recognizes the trustee, the holder of the legal title to whom dividends are paid. The trustee, however, is at times in doubt as to whom the dividend is payable. If the dividend is cash, it belongs to the life tenant as income, unless it be a liquidating dividend returning capital to the stockholder. If the dividend is a stock dividend, however, there is a division of authority. Some states, following the so-called Pennsylvania rule, apportion the stock dividend between the life tenant and remainderman, giving the life tenant the stock represented by accumulation, as shown by the corporate records, since the death of the decedent, and the balance to the remainderman as principal. Other states apply a simplified rule giving all cash dividends to the life tenant and all stock dividends to the remainderman.

9. Stockholders' Appeal in Case of Withheld Dividends. If at any time stockholders should feel that directors are withholding profits that should be paid as dividends, they may appeal to a court in equity to compel the directors to distribute such profits. At times, directors will deliberately hold back profits from stockholders for ulterior purposes. To prevent possible fraud on the part of directors of a corporation, stockholders can

compel the payment of dividends, but only if evidence of fraud can be clearly proven to the court. Courts, as a rule, will not interfere with the actions or decisions of the directors of a corporation in either dividing or withholding profits, unless actual fraud or a wilful abuse of discretion has been shown.

The reason for judicial conservatism in this respect is apparent. As an illustration, consider the position of many American corporations that, during and immediately after the World War, built up large surplus accounts. The condition of their balance sheets would have appealed to any one as warranting liberality in dividend distributions. Yet many of these corporations found it necessary to utilize surplus to charge down enormous inventory losses a few months later. If, in the meantime, a court had ordered a dividend distribution in some of these corporations, this court order might have been the direct cause of bankruptcy and liquidation. In a Pennsylvania case the court sustained the action of directors in refusing to pay preferred stock dividend, because the contract indicated, in language as strong as it could be made, that the directors were required to pay the dividend if earnings were available. The directors pleaded merely that they wished to retain the surplus for working capital and contingencies. This was held to be a sufficient reason by the court.

It follows, therefore, that the directors have wide latitude in setting aside earnings for working capital and other proper purposes, and in addition to this, most modern charters and by-laws expressly confer this power on the board in far-reaching language. The customary legal remedy that stockholders have is to await stockholders' meetings and there express their views regarding the dividend policy of the board, and if the objectors can obtain sufficient support, they have the privilege to change managment by electing other directors.

It does not follow, however, that the board can abuse its position in exercising the discretion. If a stockholder can show that the board is paying officers exorbitant salaries, or is transacting or threatening to transact business outside the powers of the charter, the court may order a dividend paid. In the well-known case of Dodge Brothers vs. Ford Motor Company, the

Ford Company was ordered to pay a dividend where the officers proposed to invest surplus in a plant that its charter did not authorize it to operate.

10. Dividend Rates.—Dividends are paid to stockholders owning different classes of stock, in proportion to the number of shares of stock of certain kind or kinds owned by each stockholder. It is illegal to pay different rates per share of stock in a given class. When, however, a corporation has outstanding different classes of stock, such as common stock and preferred stock, the dividend rate or the amount per share for each class may be different, according to the terms of the contract under which the stock is issued.

11. Forms of Dividends.—The form which a dividend may take may be cash, property, stock of the corporation itself, or scrip.

Dividends are either *regular, extra, special,* or *liquidating.* It should be the aim of directors of well-managed corporations to maintain a regular dividend rate. By doing so, the stock of such companies will attain a higher investment value, and the corporations' credit rating will be higher than would be the case had the corporations paid dividends on a fluctuating scale. Moreover, stock with a record of regular dividend payments is more highly regarded by financial institutions, and the securities of such a corporation have a better value for collateral purposes. In addition to this, the laws of some states will classify certain stocks as legal investment, only if there is an unbroken record of dividend payments over a period of years. This makes regular dividends a prime requisite in such cases. In Pennsylvania, owing to a constitutional provision, stocks or bonds of corporations are not legal investment for trust funds.

For the 10 years beginning with 1913, the United States Steel Corporation paid dividends annually on their shares of common stock as follows: 1913, 5 per cent.; 1914, 3 per cent.; 1915, $1\frac{1}{4}$ per cent.; 1916, $8\frac{3}{4}$ per cent.; 1917, 18 per cent.; 1918, 14 per cent.; 1919, 5 per cent.; 1920, 5 per cent.; 1921, 5 per cent; 1922, 5 per cent.

This makes an average, for the 10 years, of 7 per cent. During the same interval the National Biscuit Company paid regular dividends of 7 per cent. each year. Both companies, therefore, had the same average rate of dividends for the 10-year period. Nevertheless, the price of the common stock of the United States Steel Corporation during the period averaged $85.5 per share, while the average price of the stock of the National Biscuit Company was $115.50 per share.

12. If, at any time, profits are available for distribution among the stockholders at a rate higher than that of the regular dividend, directors usually declare the regular dividend and an additional extra dividend, but do not change the regular dividend rate until the earnings over a series of years have been found large enough to warrant the change of the regular dividend rate to the higher rate, which can be regularly maintained should the directors adopt it. It is far safer to let the stockholders know that their investment is yielding them a regular return, and that the extra dividend is a bonus given to them because of favorable business conditions that, for the time being, have made possible larger profits. It would be unwise to make the stockholders feel that these additional bonuses were to be given to them regularly. During the war, many large American corporations made excessive profits, and were able to pay extra dividends, but in most cases they were clearly separated from the regular dividends. Many corporations invested a portion of their war profits in Liberty bonds and later declared a special dividend to their stockholders in the form of Liberty bonds. Such dividends were quite common 6 or 8 years ago. They help to emphasize the difference between regular cash dividends and extra dividends, although extra dividends may be paid in cash or in property.

Most conservatively financed corporations did not change their regular dividend rate during the war period. It is the boast of some of our large American corporations that they have been paying regular dividends at a fixed rate for a long series of years. Such companies as the National Biscuit Company, the Diamond Match Company, Swift and Company, the Pullman

Company, and the Westinghouse Air Brake Company have paid regular dividends for over 30 consecutive years.

The directors of the corporation decide which shall be regular dividends and which extra dividends. It is common for corporations to number and label their dividend checks sent to stockholders either as regular dividend or as extra dividend. Sometimes directors of a corporation will find that their assets are not in such form that they can be used to pay regular dividends. Their current assets may consist largely of inventory of finished goods or they may be invested in raw material bought at a favorable price, or the assets may be represented by receivables due in the near future. Rather than suspend the payment of regular dividends, the directors of the corporation, under such conditions, may borrow the necessary funds from banks to pay dividends, pledging as security their accounts or bills receivable, or they may issue a scrip dividend, or in extreme cases, they may issue fresh securities to obtain liquid funds for the purpose. Of these methods borrowing is most objectionable unless it is very certain that, owing to postponed collections or other special circumstances, funds for the purpose are only temporarily unavailable, as when a harvester company awaits collections upon the harvesting of crops by their farmer debtors. Issuing securities is also of most doubtful expediency, although at times it may be justified when a corporation is attempting to maintain a market for its stock and it has no other source to obtain funds to pay a regular dividend about to fall due. In such case, care should be taken that there is in reality a bona fide surplus against which to charge the dividend. Otherwise the management may find itself in the unenviable position of having paid capital in dividends derived from a stock-selling campaign conducted through the United States mails. This practice may easily lead to criminal charges and the resulting aftermath of ruined reputations.

13. A scrip dividend is the issue of promissory notes to stockholders. The corporation issues to the stockholders a promissory note, due on a certain date, for the amount of the dividend, with the understanding that the note is to bear interest

and be paid in cash at a given date by the corporation. By the use of scrip dividends, the stockholders are assured of their earnings on their investment, and if they sell their stock holdings after the scrip dividend has been issued, they may retain their claim on the earnings of the corporation to the extent of their scrip. If the directors were to suspend the payment of regular dividends when the company had actually earned the amount necessary for these dividends, but when profits could not be made available at the time, it would be manifestly unjust to the persons who would thus be compelled to sell their stock, perhaps at a lower price because of the suspension of dividends, and to allow the future stockholders to share the profits that had been earned on the investment of the former stockholder. This is overcome by the issuing of scrip dividends. It is not considered a proper business practice, however, to issue scrip unless liquid funds will be available at maturity of the scrip.

14. Putting Earnings Back Into the Business.—When a corporation has established itself in a certain line of business and has profits that can be divided in the form of dividends, the next question for the directors or financial managers is to determine what part of these profits shall be paid out in the form of dividends, and what part shall be kept in the business for working capital and for improvements and extensions of the corporate property. Sometimes directors are anxious to make a favorable impression on the stockholders, and in so doing pay too large a proportion of the profits in dividends. They may thus impair their working capital and make impossible the necessary improvements. It is, therefore, a matter of importance that the directors should carefully estimate the necessary expenditures to be made out of past earnings to meet the future requirements of the business.

It follows that though the surplus is substantial, a portion of it should be retained in the business. In determining the proportion to be retained, many factors are to be considered. One way to approach the subject is to consider the nature of the business carried on and the stability of net earnings in some cases, as compared to fluctuation of earnings in others. A business

that is stable, and with steady demand for its service or product, can ordinarily pay a larger proportion of earnings in dividends than a business in which there is a demand for its output only in prosperous times. Thus, a railroad company, carrying commodities of many lines of industry and having a steady demand for its service, experiences less fluctuation in earnings from year to year. It may therefore pay from 50 per cent. to 75 per cent. of its earnings to stockholders, whereas a jewelry business, earning larger sums in prosperous years, and nothing in lean years, should retain 50 per cent. to 75 per cent. in the business and pay the smaller percentage in dividends. The policy of the Pennsylvania Railroad has been to pay a dollar of earnings in dividends for a dollar put back into the property. As this road is one of the most ably managed properties operating today, this is considered to be a model for railroads to follow. Industrials, it is considered, should be even more conservative and pay out perhaps only 25 per cent. to 40 per cent. in dividends.

In any event, every business should look well to the future in its dividend policy, and in determining the proportion of profits to pay in dividends should consider a 5- to 10-year period and then pay only on the basis of an expected average earning, or at times even on the basis of the worst years under the worst conditions.

It is not always considered imperative that funds for expansion should be derived from earnings put back into the business. Extensive improvements usually call for fresh capital investment procured by the issue of additional securities of the company, such as a stock, bond or note issue. In public utilities it is not the practice in modern times to expand at all by holding back earnings from stockholders. In fact, an attempt to do so would probably result in a compulsory reduction of rates for service. When rates are fixed by service commissions, no allowance is made for expansion, it being the practice to regulate the rates on the computation of cost of service, depreciation, and fair return in the investment. The management is thus given no opportunity to build up surplus except for current needs on the basis of existing property.

15. Budgets.—Such estimating of necessary disbursements for a period of time is called budgeting. A budget is an estimate of the expenditures necessary to conduct the different departments of an enterprise over a period of time. As a rule, business men who make budgets for their businesses do so for a period of one year.

In preparing the budget, the sales department must first forecast its sales. On the basis of this estimate, the buying and operating departments will make their estimates of costs of raw materials and labor. In addition to this, an estimate of the administrative and maintenance expenses must be carefully made. And lastly, an estimate of the disbursements for expansions and improvements or betterments must be included in the budget.

In a pamphlet published by Ernst and Ernst, Certified Public Accountants, the many advantages of a carefully prepared business budget are enumerated:

1. It aids in the most economical use of working capital, since it makes a careful survey of the most effective use of fixed and current assets.

2. It prevents a certain amount of waste, since it regulates the spending of funds for a definite purpose, according to appropriations estimated by the heads of different departments.

3. It places responsibility for each act committed in the business, just where it belongs. When for example, it is found that there is a sudden increase in the cost of a product, it is not difficult to determine just where the mistake in planning was made.

4. A carefully prepared budget makes for coordination and cooperation among the different departments of the business.

5. The data contained in the budget, if carefully prepared, present the best judgment of the business executives, thus guarding against overexpansion of any one department, or general overexpansion of the business.

6. It serves as a safety signal for the management, since it shows the difference between estimates and actual results obtained from time to time. It also becomes, as it were, a check on the judgment of the business executives who have planned the budget.

7. It helps the management in determining the effect of sales, production, and financial policies.

8. It necessitates careful study of market conditions on the part of the management, thereby disclosing various ways and means of expanding the business.

9. It compels the business management to plan for the most economical use of labor, materials, and funds, in order to keep expenditures within budget estimates.

10. It is the only means of determining in advance to what extent new financing will be necessary.

These are some of the outstanding advantages claimed for a carefully planned business budget.

16. When such a carefully prepared budget has been made, the directors of a corporation will have a standard by which to judge the amount of earnings or profits that should be set aside to meet the necessary expenses for a certain period. It is not necessary to set aside an amount out of past profits to finance all the estimated expenditures in the budget for the whole year. This might be necessary if collections for goods sold were made only once a year; in other words, if all the trade customers paid their bills on the first of January for whatever they bought in the course of the year. Even then, it would not be necessary, because these accounts receivable could be used as collateral for loans from commercial banks. Most businesses are not conducted in this way. A well-managed enterprise tries to have its bills mature from day to day so that a certain amount of cash will be constantly flowing into the cash fund, for if cash funds are not regularly forthcoming from this source, a company may soon find itself in difficulties. Moreover, expenditures for expansion and improvements, when made, are usually fairly large. It therefore takes time to build up the necessary fund out of earnings to pay for such expenditures, and the directors of a corporation must make liberal allowance out of past earnings for such expenses.

It is sometimes contended, as heretofore stated, that improvements and expansions of corporate property should be financed by issuing new capital rather than by depending on earnings. It

is argued that since the value of the assets is increased because of the investments in corporate property in the form of new equipment and expansion of plant, such expenditures should represent fresh capital. Not all expansions, improvements, and betterments, however, can properly be paid for by increasing the outstanding capital stock or by issuing bonds or other securities. Many so-called improvement expenditures do not greatly increase the earning power of the business, but may be necessary in order to keep the plant and equipment up-to-date. When, for example, a railroad substitutes a steel bridge for a wooden bridge and a concrete bridge for a steel bridge, such expenditures for improvements will not materially increase the earnings of the railroad; they will merely keep these earnings from decreasing. When, because of competition, a manufacturing concern invests in new machinery in order to keep pace with its competitors, this expenditure may also fail to increase materially the earnings of the company. All construction expenditures that do not increase the earnings of the business should, therefore, be paid for from earnings.

Not only improvements and betterments of certain kinds must be paid for out of earnings; a certain amount must be set aside for maintenance of plant equipment. Unless, therefore, the directors make a very careful estimate of the necessary requirements of the business for a period of time, and provide for these requirements out of the past earnings or profits, there is always the danger of impairing the future efficiency of the business by adopting a too liberal dividend policy.

In general, the rule may be laid down that a conservatively financed corporation will pay no dividends for a considerable time after it begins operations, and that in any one year only a portion of the profits will be distributed as dividends. On the other hand, the rule regarding the provision for future requirements out of earnings may be based on the fact that all improvements and expansions that will not materially increase the earnings of the business should be financed out of earnings, and not by issuing additional stocks and bonds. In any case, if funds are expended for improvements or extensions, the outlay for the purpose must be capitalized on the books of the corporation, and

cannot be charged to expense unless the improvement is such that the property produced or added has a relatively short, useful life to the business.

MANAGEMENT OF CORPORATE INCOME

17. Undivided Profits.—After the directors have distributed earnings in the form of cash dividends, the next question pertains to the management of the undistributed or undivided profits. When a corporation begins business, its assets will ordinarily be in the form of building, plant, equipment, materials, and cash. These assets are what the business owns. On the other hand, the liabilities will be represented by capital stock and possibly by bonds. Its liabilities are what the business owes to the stockholders, bondholders, and creditors. If the business is successful and makes profits, after a period of time these profits will normally be reflected in an increase in the value of such assets as cash, securities, accounts receivable, and inventory. Again, if some of the cash is taken to make improvements to buildings and to buy additional machinery or equipment, the value of these assets will also tend to increase. The corporation is owned by the stockholders who consequently have a claim on the increased value of the assets. Since, however, the value of the capital stock is usually carried on the books at a figure that represents the par value of stock issued, the increased property claims of the stockholder are ordinarily referred to as corporate surplus.

The surplus is the difference between the assets and the liabilities of a corporation. It appears on the financial statement of the concern as a liability, since, if the corporation is dissolved, it is owed by the business to the stockholders. Sometimes the financial statements of corporations do not subdivide surplus, but group it as one item on the liability side of the balance sheet. The balance sheet is merely the statement of the assets and the liabilities of the business, and must balance, since for everything that is owed there is an owner. Thus, for example, the balance sheet or financial statement of an incorporated business may be made up in either of the following two ways:

NUMBER ONE

Assets		*Liabilities*	
Plant and equipment	$100,000	Capital stock	$50,000
Finished goods	10,000	Bonded debt	50,000
Accounts receivable	10,000	Accounts payable	5,000
Raw materials	5,000	Notes payable	5,000
Securities	10,000	Surplus	40,000
Cash	15,000		
	$150,000		$150,000

NUMBER TWO

Assets		*Liabilities*	
Plant and equipment	$100,000	Capital stock and surplus	$90,000
Finished goods	10,000	Bonds	50,000
Accounts receivable	10,000	Notes payable	5,000
Raw materials	5,000	Accounts payable	5,000
Securities	10,000		
Cash	15,000		
	$150,000		$150,000

18. We have defined the surplus of a business as the excess of assets over liabilities. Where does this surplus come from? It is derived from a large number of sources. In the first place, it is obtained from the earnings arising from the regular operation of the business. This is the main source of business profits. Profits that are not distributed in the form of cash or property dividends are added to the accumulated surplus. The second source of surplus is the earnings derived from other than the regular operations. Third, corporations derive income from the securities which they hold either as investments or for the purpose of controlling other companies. When, for example, a business decides to set up a reserve for depreciation of plant, it will not ordinarily keep the cash in its safe, but will invest it in securities or in improvements to its plant. These securities should yield an income in the form of either interest or dividends. Moreover, if the corporation owns securities of another company in order to control this second corporation, these securities may yield an income to the company which owns them. During the war, a large number of corporations invested

a portion of their earnings in government bonds, which yielded them a definite income.

An increase in surplus may follow the sale of corporate assets no longer needed for the conduct of the business at a price above their original cost, less depreciation. For example, a corporation may find that it does not need all of the land it has bought for its plant, or possibly for expansion of plant, and, because of the growth of the community, it is able to sell a portion of this land at a good margin of profit. The profit thus obtained may form an additional source of surplus. Also, in a period of rising prices, it may happen that the value of the corporate property will increase considerably because of its increased earning power. Under these conditions, corporations have often revalued their assets by increasing the book value, and thus accumulating further surplus. This process of writing up assets in order to create a surplus, is not to be recommended; most business men today realize that such values may come down sooner or later. Sometimes corporations that have been successful, will be able to sell their securities at a premium. In other words, a corporation may sell its stock having par value at $100 per share at $125 per share. The amount of each share of the capital stock is a liability and would be represented by $100 per share, and $25 per share additional would go to surplus. This is sometimes called paid-in surplus.

The foregoing are the main sources of corporate profits that help to build up the surplus account. In some corporations, it has become a practice to divide the funds in the surplus account into groups, such as undivided profits or reserve for working capital. The purpose of any such division is merely to let the stockholders know that not all the surplus is available for possible dividends to the stockholders, and that a portion of it must be kept in the business.

19. Stock Dividends.—There are a number of possible ways of disposing of this surplus. The manner in which cash dividends are paid out of corporate profits, as well as the possibility of dividing corporate property in the form of corporate securities, such as Liberty Bonds, among the stockholders, has

already been indicated. By this process the surplus of the corporation is definitely reduced, since it has actually given up to the stockholders some of its assets. When, however, a corporation wishes to keep assets in the business and at the same time inform stockholders that the value of their assets has increased, it will proceed to give them additional shares of stock in the corporation. This process of "melon cutting," as it is popularly called, is referred to in technical language, as declaring a stock dividend. The term stock dividend means merely that the stockholders receive more stock in their own corporation. In reality, nothing is divided among the stockholders which they did not previously own. The stock represents the ownership of the company. To multiply shares does not increase property value. When a stock dividend is declared, it is merely the transfer of a portion of the surplus account to the capital account, and does not reduce the assets or the liabilities, of the corporation. It gives the stockholders evidence of the fact that their corporation has been successful, and this evidence is often looked upon by the stockholders as something having definite value. Why, then, will corporations declare stock dividends? From the standpoint of the business, the policy of declaring stock dividends is regarded as sound financing, since it permanently capitalizes the increased value of the assets. So long as the assets have not been capitalized, that is to say, so long as they have not been expressed in par value of securities, they may, at the discretion of the directors, be converted in part into cash and paid out as cash dividends. The surplus would thus be reduced, and the assets reduced to correspond. On the other hand, when a surplus has been capitalized, it is no longer possible to use the enlarged value of the assets for the purpose of cash dividends, since this would be paying dividends out of capital, which is illegal.

A second reason why corporations have declared stock dividends is that many corporations have built up very large surplus accounts out of earnings, and have not paid out the earnings in cash dividends. Because of the high rate of federal income tax and surtaxes which the possible recipients of such earnings would have had to pay, the earnings have been kept in the busi-

ness from year to year and the surplus has been allowed to accumulate. On the other hand, the Supreme Court of the United States has decided that stock dividends are not to be regarded as income, and therefore are not subject to the income tax. When this decision was rendered in 1921, many corporations that had accumulated large surpluses declared stock dividends. On the other hand, some of the more conservative financial managers of corporations realized that the capitalization of the surplus, by issuing such dividends, might cause financial difficulties to the corporation at a later date, by reducing the margin of surplus on which to draw for cash dividends in a possible period of depression. They, therefore, did not capitalize the surplus, but allowed it to accumulate from year to year, until in some instances corporations carried surpluses on their books well in excess of their capital stock. This was observed by the Congress and the passage of a law to tax the accumulated corporate surplus not needed for the reasonable conduct of the business, caused many corporations in 1922, and early in 1923, to declare stock dividends. It has become apparent by more recent developments that capitalizing of surplus by declaring a stock dividend does not overcome the possibility of tax on accumulated surplus, and that surplus not reasonably necessary for the needs of the business, which is retained with the obvious intention of escaping surtaxes by the stockholders, will subject the corporation to the additional tax.

During 1922 and the early part of 1923, different financial journals of the country reported the declaration of stock dividends by no less than 362 large corporations. The aggregate face or par value of these stock dividends was $2,285,018,636. A large variety or corporations were listed among those declaring such stock dividends, including 31 oil companies, 64 machine and tool factories, 67 textile mills, 21 industries manufacturing food products, 18 public utilities, 15 mercantile establishments and over a hundred miscellaneous corporations.

These huge stock dividends gave the public at large an indication of the extent to which corporate surpluses had accumulated and had been reinvested in the businesses. Most of these surpluses had been derived from large corporate earnings, not

paid out in cash dividends, with a view possibly to evade the high surtaxes that individuals receiving these incomes would have had to pay.

That this extensive declaration of stock dividends on the part of so many corporations over a relatively short period was not unsound fiscal policy or rash financing, from the viewpoint of the corporations, can be gathered from an examination of the financial statements of these companies. The cash dividends paid by 177 of these corporations, whose financial status was examined, in 1921 was on an average of 10 per cent. It should be remembered that 1921 was a poor business year and corporate earnings were relatively low. When we add the stock dividends declared by these companies to the outstanding stock, the 1921 dividends would still represent more than 5 per cent. return on the new capitalization. This would indicate that these companies in general were not pursuing an unsound financial policy, which might later impair the credit, even though their actions attracted much public attention and invited a great deal of unfavorable criticism.

From the investor's point of view, the stock dividend is usually acceptable because it gives tangible evidence of the prosperity of the business and furthermore decreases the value of each share of stock proportionately, thus making possible a wider market for his security. For illustration, a corporation having accumulated a large surplus, has a market value of its outstanding stock in the vicinity of $200. It decides to declare a 400 per cent. stock dividend, which means that for each share of stock outstanding, four additional shares will be received. In other words, the owner of one share of stock will now have five shares of stock in the corporation and the market value of each share, for the time being, will be about one-fifth of its former value. As a rule, however, it will be found that the market value of such shares will be somewhat higher than one-fifth the market value of the old shares, because of the smaller cost per unit. The larger number of buyers who will be drawn into the market for them will tend to raise the market price. Furthermore, it is generally anticipated that the dividend rate will also be increased very soon after a stock dividend has been declared, and this

tends to affect the value of the stock. If, for example, a share of stock, selling at a market value of $200 has been paying $10 dividend a year (10 per cent. on $100) the rate of dividend on the new capitalization of five shares for one share would probably be $4 a share. Since, however, successful corporations would not ordinarily continue this small rate of dividends very long, but would soon increase the dividends, the chances are that the stock would rise in market value, and thus afford a source of profit to the stockholder. In consequence, stockholders will usually find the capital value of their shares of stock increased by virtue of a stock dividend. If they should convert all or any part of their stock into cash, subsequently, any profit realized on the sale of these securities, is regarded as income and subject to federal income tax. If, for instance, a person has bought ten shares of stock at $100 per share he will have invested $1,000. If a 400 per cent. stock dividend is declared and he receives five shares of stock for each share he originally purchased, he will own 50 shares of stock. His corresponding investment in one of these shares will be equal to one-fifth of his investment in each share originally, or $20 per share. If he were to sell one of these new shares for $30, he would have realized a profit of $10, which amount must be declared as income, according to the Federal Income Tax Law.

TAXES

20. Forms of Taxes.—One of the most important items of expense to which business is subjected is outlay for taxes. Taxes are imposed and collected by the federal government, by the states, counties, cities, and various municipalities. As such, these are commonly referred to as federal, state, and local taxes.

Federal taxes are uniform throughout the country. State taxes vary according to the laws of the respective states in which the business may be transacted or its property located. Local taxes vary even within the same state.

21. Federal Income Taxes.—Federal income tax is based on the so-called net income of corporations, trusts, partnerships,

and individuals. In the case of corporations, the net income is determined and collected according to the income tax laws of Congress and under rules and regulations issued from time to time through the Commissioner of Internal Revenue at Washington.

In order to determine the net income, gross income from all sources is first considered.

In the case of trading and manufacturing companies, and also in the case of mercantile companies, gain or loss must be determined according to the inventory system, which makes necessary the taking of inventory at the beginning and end of the taxable year, purchases and sales during the year being considered, to determine the gross profits of the business. Gross income from other sources must also be stated, such as interest, rents, royalties, profits from sale of real estate, stocks, bonds, and other assets, and dividends on stock held in other corporations.

From the total of these items, deductions may be made by corporations for various items of expense, such as compensation of officers, rental of business property, repairs, interest, taxes, casualty losses not covered by insurance, bad debts, dividends received from other corporations paying an income tax, depreciation, and other costs necessary or incident to the conduct of the business.

Individuals are also subject to a tax upon net income realized during the fiscal period. The rate for individuals is not easily computed, owing to the fact that the surtax rates upon net income in excess of a certain amount are fixed upon a graduated scale. Taxpayers with large taxable net income pay a proportionately greater tax than those having smaller income. This system is designated to place the tax burden on the wealthy class, which, it is thought, is better able to pay. In effect the tax burden is really carried by the consuming public, which indirectly pays the greater part of these taxes in the increased cost of living expenses and commodities of all kinds which are purchased.

Taxpayers are required by law to keep an accurate set of books, so that proper income of the business can be determined. Income tax reports, which must be filed by every corporation

annually, call for detailed information regarding the cost of manufacturing or producing goods; the profit realized from the sale of real estate, stocks and bonds, and so forth; an explicit statement of compensation paid to officers; a schedule of cost of repairs and of taxes paid; and full explanation of any casualty losses, together with a complete justification for deductions covering depreciation.

The income determined under the tax laws is not necessarily the income shown by the books of account, owing to the fact that certain items of income may be tax-free, and items of expense may not be allowable deductions under the law, notwithstanding the fact that these are properly computed in the books of account. Among deductions not allowable are income taxes paid to the federal government. This may be a large item of expense, but not an allowable deduction under the law and regulations. On the other hand, dividends received from other corporations are required to be returned as gross income, and yet these dividends are fully deductible if the corporation paying the dividend is itself paying an income tax.

22. State Taxes.—In the State of Pennsylvania, corporate taxes are based on a property-tax system. Corporate property in the state, subject to taxation, is valued with due regard to liabilities. The earning power of the company is also taken into consideration, and the value of the corporation's stock, as indicated by sales of the stock throughout the year, is set forth.

The Pennsylvania system is a capital-stock plan, which is almost identical with the federal capital stock tax system. Under this plan, we find that three tests are imposed, and of these three the one which produces the highest valuation is fixed as the tax assessment on which the rate of five (5) mills on the dollar is imposed.

The Pennsylvania system illustrates difficulties which states are under in collecting taxes on a proper basis. Since the tax is a property tax, it can be assessed only against property permanently located in the state. Real estate is, of course, permanently situated in the state where it is found. Personal property is to be divided into two classes: tangible and intangible.

The intangible personal property follows the corporation to the state in which it is chartered for taxation purposes where the property-tax system is used, whereas tangible personal property is taxable where located.

Pennsylvania also imposes a gross receipts tax on transportation companies of various kinds.

Most states employ the franchise tax system, or the property-tax system. There is a growing tendency, however, by many states to install the income-tax method as a means of producing state revenues.

A larger part of revenue from taxation is derived in most states from tax upon real estate. For the most part, however, real-estate taxes are collected for the benefit of local government, such as cities, towns, boroughs, and townships. This tax is imposed ordinarily on individuals and corporations alike at a rate fixed from time to time by the local authorities. The demand for revenue for local purposes is very large, and at the present time is 80 per cent. higher than the federal. In President Coolidge's annual message to Congress in December, 1924, he called the attention of the country to the fact that the federal expenditures were approximately three billion five hundred million dollars ($3,500,000,000), whereas the expenditures for state purposes were approximately seven billion dollars ($7,000,000,000).

Taxes to be paid to state authorities depend, of course, upon the jurisdiction of the various states to tax the business. A business may be taxed in the state in which the corporation is chartered, and also in such other states as the corporation may maintain offices, carry on business or hold property. The system of taxation in the various states is governed entirely by the laws enacted by the local state legislatures. Generally speaking, state corporation taxes are variously imposed as a property tax, as a franchise tax, or as an income tax. In those states in which the franchise tax is imposed, the system of computing the tax is the most easily understood.

As an illustration, the state of Delaware imposes a franchise tax based on the authorized capital stock specified in the corporate charter regardless of the amount of property which the

corporation may own or of the income that it may have. The rate of tax is fixed by statute in Delaware, and is at the following rates:

Capitalization not exceeding..	$ 25,000	$ 5.00
Capitalization not exceeding..	100,000	10.00
Capitalization not exceeding..	300,000	20.00
Capitalization not exceeding..	500,000	25.00
Capitalization not exceeding..	1,000,000	50.00

For each additional million or part thereof, $25.00.

REPAYMENT OF CORPORATE DEBT

CLASSES OF DEBTS

23. The debts of corporations are of two classes: First, there are the unsecured and short-time debts, also spoken of as floating debts, or unfunded debts. They are represented by accounts payable and notes payable of all kinds, which mature over a relatively short period of time. Sometimes, however, these short-term notes are definitely secured by collateral securities in the form of stocks and bonds. For example, when the Seaboard Air Line issued its $1,000,000 7 per cent. notes, which were to run from September 15, 1920, to September 15, 1923, it pledged as security $1,500,000 of its first and consolidated gold 6 per cent. bonds. Short-term debts are called unfunded debts, since no definite provisions are made at the time the debts are incurred for their repayment, and no definite fund is set aside out of the earnings for this purpose.

Second, there are long-term debts in the form of mortgage, collateral trust, and other kinds of bonds. These debts are often spoken of as secured, or funded debts. They extend over a relatively long period of time, from 10 to 30 years and longer. These bonds are usually secured by lien, or definite claim, upon some property. It is not necessary, however, that such long-term bonds should be secured by pledging specific property, or collateral for security. Frequently, long-term bonds are issued

without definite provisions being made for their refunding or repayment. The difference, therefore, between funded and unfunded debts, is one which is more apparent than real. It merely indicates a difference in the periods of time over which such debts extend, the former usually extending from 2 to 3 years, or, at most, 5 years, and the latter for longer periods.

CONVERTING CORPORATE DEBTS

24. Converting Bonds Into Stock.—A corporation deciding to pay off its debt may do so in one of three ways. First, it may convert or change the outstanding bonds into stocks, and thus make the present creditors of the enterprise part owners of the business. Many corporations have issued so-called convertible bonds in past years. As the term implies, the bonds can be converted or changed into some other type of security of the company; as a rule, into either preferred or common stock. The conditions and terms on which such an exchange can be made are stated in the bond contract. Ordinarily, convertible bonds can be exchanged for the stock of the corporation at a definite par value, over a stated period of time.

The privilege of converting bonds into stock of the corporation is often very attractive to investors who want security for their investment, and who, at the same time, appreciate an opportunity to share in the increase in the value of the stock due to prospective prosperity. The value of the stock will ordinarily rise with the increasing rate of dividends that are paid, and these higher dividends are made possible by increased profits. Since convertible bonds can be exchanged for stock of the corporation, the market value of such bonds, will, in turn, rise with the market value of the stock into which they can be converted. The bondholders can then convert their bonds into stock, and instead of receiving a regular rate of interest on their bonds, can obtain the higher dividends on the stock.

A further advantage of convertible bonds, from the viewpoint of concerns issuing them, lies in the fact that when bonds are converted into stock, fixed interest charges are reduced. If, for example, a corporation has outstanding convertible bonds to the

extent of $100,000 and these bonds are later exchanged for stock, the actual indebtedness of the corporation will have been removed. Ordinarily, the bonds thus converted into stock are canceled by the corporation and cannot be reissued. Sometimes, however, the mortgage under which the bonds have originally been issued, provides that the concern may issue them again at a later date, and thus incur a new debt under the provisions of the original mortgage. The advantage of reducing fixed charges by converting bonds into stocks is, in actual practice, questionable. Bonds will usually not be exchanged for stock unless the company is prosperous; that is, unless the stock yields a higher rate of return than the bonds. But if a business is not in a position to pay such higher rates of dividends, it will not be able to induce the bondholders to convert their holdings into stock. Such a prosperous business would thus be able to carry the fixed charges for its outstanding bonds without difficulty, and, if the bonds were not convertible, would leave an even larger amount available for dividends among stockholders. If, for example, a corporation had $1,000,000 in capital stock outstanding, and $1,000,000 in convertible bonds, then net profits of, let us say, $200,000 available for distribution as dividends, would have to be divided among $2,000,000 of capital stock, if all the bonds were converted into stock. This would mean a rate of 10 per cent. on the total outstanding stock. On the other hand, if the bonds were not convertible, but continued as a fixed charge of 6 per cent. and 1 per cent. sinking fund, only 7 per cent. of $1,000,000 would have to be set aside out of the $200,000 assumed net earnings. This would leave $130,000, available for distribution among the $1,000,000 of capital stock outstanding. It is not always to the interest of the stockholders to have convertible bonds outstanding, since such bonds may not only reduce their profits but may even result in wresting control of the corporation from them. This is only one of the reasons why corporations will often issue Class A and Class B common stock, the former with voting power, the latter without. Then the bonds can be made convertible into Class B stock, earnings being shared proportionately with Class A stock, but control of the corporation being assured to the holders of Class A stock.

From the viewpoint of the investor, convertible bonds are a good security, since they have all the features of bonds and, at the same time, offer possibilities of sharing in business profits. As has been noted, the convertible bonds will usually rise in market price with the rise in the market price of the stock into which they can be converted. On the other hand, they will not fall as low in market price as the stock of a company that has little chance of earning dividends on its stock for some time to come. The reason for this is obvious. The bonds yield their owners a definite rate of interest, which gives them a certain market value as long as the business is solvent, whereas the stock is not earning any dividends and, therefore, has a relatively low market value.

By converting bonds into stock, a corporation may, therefore, extinguish or pay off its outstanding debt by making the creditors part owners of the corporation. The process is really similar to selling additional stock and using the proceeds from such sales to retire the outstanding bonds. The capitalization of the concern remains approximately the same, but one form of security has been exchanged for another.

25. Paying Off Bonds in Cash.—The second method of extinguishing the bonded debts of a corporation is to pay them off in cash. When these bonds are paid off in cash they are said to have been redeemed. Such redemption may take place in various ways. In the first place, the bonds may be paid off when they mature, at the end of a certain number of years. Second, they may be paid off before they mature, by making them callable on the part of the corporation issuing them. Third, they may be paid off by buying them in the open market out of funds derived from earnings.

There are a number of reasons why business corporations will want to pay off or retire their bonded debts. Some businesses are of such a nature that their earnings are very uncertain, and, although they may be in a position to borrow, presently the security which they can offer may vanish. A corporation may be able to borrow funds to develop an industry for the purpose of manufacturing a novelty, which will find a strong demand for

the time being. Novelties often have a short life and the plant and equipment used for their manufacture may very soon prove worthless, except as so much scrap.

Again, some properties are of such a nature that their assets are wasted; that is, used up in the normal conduct of business. This is true, for example, of mining and lumbering companies. With every ton of minerals that is mined or with every thousand feet of lumber that is cut, the value of the assets represented by mineral deposits and forests decreases. Companies that have borrowed funds to buy mining or timber lands, must, therefore, provide for retiring these debts out of earnings, so that when the property has been used up, the debts will be paid.

Third, certain kinds of companies are formed for only a short period of time. A corporation may be formed to buy and develop specific tracts of land near cities. These real-estate development companies may borrow funds with which to buy a tract of land and to make necessary improvements to the land. When the actual lots or sites have been sold the purpose for which the loan was made will have been accomplished. The ownership of the land will have passed into the hands of others. It is, therefore, necessary to provide for a fund out of the proceeds of the sale of such property to repay the original bondholders.

There are, however, certain types of enterprises that may be said to continue their debts indefinitely. These are chiefly railroad companies, street railway companies, gas, water, and water power and similar companies. The property pledged as security for a loan by such companies, if it is kept in a normal state of repair, may be said to be useful for an indefinite period of time. As one part wears out, it will be replaced, and thus the usefulness of the entire property will be maintained. Such companies do not have to retire or pay off their indebtedness but can continue their capital obligations indefinitely. Most business corporations today are not in such a favored position, and therefore must provide for the payment of their obligations. When the outstanding bonds are mortgage bonds or collateral trust bonds, the method of repayment is generally stated in the

mortgage. As a rule, it is required that a definite fund shall be set up out of the earnings to pay the bonds when they mature. This fund set aside out of earnings for the repayment of bonds is called a sinking fund. The sinking fund is usually deducted at regular intervals from income and paid over by the debtor company to the trustees specified in the corporation mortgage. The trustee who receives this fund applies it as provided in the mortgage. It may be used in one of several ways. First, the trustee may buy up the bonds issued under the mortgage and thus decrease the outstanding debt. The mortgage may provide that the bonds may be issued again at a later date, if the market is favorable for the bonds, or that the bonds shall actually be canceled. Second, the trustee may draw by lot, at stated intervals, certain of the outstanding bonds for retirement. The main objection to this method of using the sinking fund for compulsory retirement of outstanding bonds is the fact that bondholders who want a permanent investment do not know when their bonds may be paid off, and when they will be required to reinvest. In order to compensate the investor for his loss of interest during the interval between the payment of one bond and purchase of another, it is commonly provided that when bonds are drawn by lot for redemption they are bought back at a premium, say 101 or higher. Finally, the trustee may invest in other securities the funds paid in the sinking fund, or make loans of the funds to the debtor corporation, for purposes of expansion and improvements to the property.

In comparatively recent years it has become a practice for corporations to issue serial bonds. Serial bonds are those which mature over a series of years, a certain number each year. From the standpoint of the corporation issuing such bonds, they have the advantage of reducing the outstanding debt periodically. This means a reduction in the fixed charges as the bonds are retired. From the standpoint of the investor, on the other hand, serial bonds appeal to different classes, those who want to invest in safe securities for a relatively short time, as well as those who want to invest for longer periods. By having different blocks of bonds maturing at different times, it is possible to appeal to many classes of investors, and so greatly broaden the

market for the bonds. Furthermore, as series after series of these bonds is retired or paid off, the security behind the remaining outstanding bonds is continually increasing, until finally the holders of those last coming due will have security that may be worth many times their actual investment.

Sinking fund provisions for the retirement of bonds may be made in one of several ways. First, a definite fixed amount may be set aside each year for sinking-fund purposes. For example, a corporation may be required to pay 10 per cent. of the outstanding debt to the trustee each year, and thus retire its indebtedness in the course of approximately 10 years. Again, increasing instalments may be required every year, until finally an amount has been built up to retire the bonds at the end of a certain number of years, as specified in the mortgage. This method of building up sinking funds has the advantage of making the fixed charges on the earnings of the corporation fairly low, when the business first begins, and increasing them as the company prospers. Third, it is sometimes provided that sinking-fund proceeds shall vary with the earnings of the company. When this provision is made, it is common to provide that a certain minimum must be paid in each year. Otherwise, it might happen that the corporation would not be paying anything into the sinking fund for several years of poor business, while the assets were continually depreciating. Finally, sinking fund requirements may be based on the extent to which the assets of the corporation are depleted from year to year. The payment of a fixed amount each year into the sinking fund has but one disadvantage. If this requirement goes into effect at once it may overburden a new concern with fixed charges at the beginning, and thus cause financial difficulties. It is, therefore, advisable, as a rule, to make sinking-fund provisions in the mortgage which do not become effective until several years after the business has been operating, or which provide for a regularly increasing amount to be placed in the sinking fund from year to year. As already noted, it is a general rule that when sinking funds are provided to vary with earnings or with depletion of assets a fixed minimum payment to the sinking fund is required.

26. Making a New Debt.—Instead of converting outstanding bonds into stocks or redeeming them by cash payments, corporations may refund a present debt by making a new debt. Such refunding of a debt is in reality not extinguishing the debt, but simply substituting a new debt for an old one. Refunding mortgages are intended to provide the necessary funds with which to pay off a debt under a mortgage that is maturing. When such refunding mortgage bonds are issued, it is common to exchange the maturing bonds for the refunding mortgage bonds. Investors will ordinarily be glad to do this, particularly if they have been receiving the interest on their maturing bonds regularly, and are satisfied with the management of the enterprise. When a refunding mortgage bond cannot be exchanged for an old bond, the new bond may be sold on the market for cash, and the proceeds used to retire the maturing bond.

FINANCING OF EXPANSIONS

27. Success Means Growth.—Every successful business should normally expand. The growth may be caused either by an increasing sale of its products in the same market or by extending the sales to new markets, or both. Sometimes new sales result from adding a mail-order business or a credit and delivery feature to the cash-and-carry method of conducting sales. Sometimes they are brought about by clever advertising. Furthermore, an ingenious sales policy and able salesmen may continually call for more production, which will induce the manager of the business to consider enlarging the enterprise.

Not only by increasing the sales of a certain line of products may an enterprise expand, but it can also increase the number of products that it carries. The manufacturing and selling of so-called by-products of industry has resulted in large increases of gross sales of a number of enterprises. An illustration of this is the meat-packing industry. Formerly, the butcher killed a steer or a pig and proceeded to dress the animal and prepare the meat for sale, allowing practically everything except the meat to go to waste, with the possible exception of the hides of the cattle, which he sold to the tanner, who made them into

leather. Today, scarcely anything is wasted in the meat-packing industry. The bristles of the pigs are used for making brushes, the bones of the animals are used in the manufacture of buttons, the refuse of the animals is used for fertilizers, etc. Certain large packing concerns have taken up the manufacture of soaps. "The soap business offers interesting examples of by-product utilization and of modification of products to suit consumers' demands," says the 1925 Year Book of Swift and Company. "One interesting phase of our soap business," the report continues, "is that it makes use of a by-product of the cottonseed oil part of our business. We went into cottonseed oil refining in order to furnish raw material for vegetable shortening. But in refining cottonseed oil, there is a material obtained known as 'foots,' which is distilled and clarified and finally appears, combined with cocoanut oil as white laundry soap."

In the process of distilling the soap substances, some of the impurities and organic matter that are removed are in the form of a kind of pitch. This pitch is sold to outside manufacturers of linoleum and roofing. In the soap business, then, which is the by-product of the meat-packing industry, a further by-product results, which in turn becomes the raw material of another industry. As a result of the use of by-products, many industries have expanded very rapidly in recent years.

Finally, a business may expand by combining, in one of several ways, with another business producing similar products. In the first place, it may buy out its competitors and thus form a larger, single business unit. The process of absorbing a competing business is called a merger. As a rule, however, the business that is competing with another business of a similar nature, if it is at all valuable, has established a certain amount of trade reputation or good-will. This is reflected, either in the name of the owner of the business, in the corporate name, or, in the name of the product. Certain names, such as Eastman, Gillette, Waterman, and Ford, at once suggest certain products. If one of these companies were to merge with another company and thus lose its identity, it would result in decided loss of trade reputation, or good-will. The method of combining competing

industries by the process of merging, is, therefore, not advisable if the companies have established good-will.

A more common method of bringing about combinations, today, is to organize, or form, a new corporation, having definite capitalization, which will arrange to buy the majority stock in a number of corporations competing with each other. Such a company, formed to hold the stock of a number of competing companies, is called a holding company. It can buy the stock of the competing companies, with cash received, either by selling its own securities, or by exchanging its own stock for the stock of the competing companies. If the holding company has bought a controlling interest in a number of competing companies it has the voting power necessary to elect directors of all the companies, and can develop a uniform policy of production and of marketing their products.

When a business expands by combining with other concerns producing similar products, either by merging or by forming a holding company, it is said to form a horizontal combination. On the other hand, when a number of companies, manufacturing materials needed in different stages of the process of production, combine, they are said to form a vertical combination. If, for example, a number of competing woolen mills were to form a combination, this would be a horizontal combination; whereas, if an iron-ore mining company, a railway and shipping company, and a steel company manufacturing definite steel products, were to combine, this would form a vertical combination. A number of horizontal combinations have been formed by retail grocers who operate so-called chain stores.

Sometimes companies will also expand by incorporating subsidiaries or underlying companies. The parent company becomes the chief stockholder in the subsidiary companies and thus obtains control over them. For example, a railway company may build a branch line by organizing a new corporation that will own the branch line. A few illustrations of the growth of business units over a number of years will show the trend that can be observed in most successful enterprises. These statistics pertain to corporate growth, but in most cases the businesses had developed through the stages of individual

proprietorship and partnership before being organized as corporations.

When the Bethlehem Steel Corporation was organized in 1904 its total assets were $43,858,000. In 1922 its total assets were ten times as much; namely, $436,880,000. In 1892 the total assets of the General Electric Company were $50,935,000. In 1922, they were no less than $355,445,000. In 1911 when the Studebaker Corporation was formed, its assets were valued at $36,476,000. By 1922, they had increased to $114,631,000. These illustrations are typical of the expansion of many successful businesses.

Whatever reasons for expansion or growth may be cited, any such expansion requires money to enlarge existing plants, to replace obsolete machinery, to buy new equipment, to get control of other industries. It thus becomes the problem of the financial manager to procure the necessary funds to expand the business enterprise.

In general, the methods of measuring the amount of funds needed for expansion are the same as those for examining, or investigating, the requirements for starting a new industry. Sometimes it is easier to determine the amount of money needed to finance the expansion of an existing business than to measure the amount of money needed to establish a new one. It may be found, for example, that a definite relationship exists between fixed capital and gross sales. The funds used to expand a business are converted primarily into fixed assets by buying additional buildings, machinery, and equipment. In the case of so-called public utilities—street-railway companies, water companies, and lighting companies—the rule commonly holds, that for each dollar of gross income, the business needs five dollars of investment. In manufacturing enterprises of different kinds this relationship tends to vary. The financial manager must, therefore, study past experience in his own business as well as the experience of his competitors. He can obtain a fair idea of the relationship between gross income, and investment in competing concerns, by examining their past financial statements and income accounts. The more careful the investigation made by the financial manager, not only of his own expe-

rience, but also of those of competing concerns, the more accurate will be his judgment as to the amount of money needed to finance the expansion of his business.

Although the funds used for expansion are employed, primarily, to obtain new fixed capital, adequate provision should also be made for additional working capital. The amount of additional working capital needed can be determined by observing the relationship between gross sales and working capital, for a number of years past; between fixed assets and current assets; as well as between current assets and current liabilities. One body of facts, thus determined, will serve as a check on the other. In this way it will be possible to make a careful estimate of the amount of working capital that should be included in the financial plan for expansion.

28. Methods of Financing.—When the amount of money needed to finance an expansion has been decided upon, the next question is: How shall the money be raised?

Expansion may be financed in several ways. First, a corporation may set aside a part of its earnings every year to be used as a fund for financing its growth. This fund may be labeled "Surplus fund," on the financial statement, or merely, "Surplus." Sums thus set aside may be carried as assets, either in the form of bank deposits, investments in good securities, or expansions of plant and equipment. When, as a result of this reinvesting of the earnings of the business, the value of the property has been definitely increased and a substantial surplus has been built up, evidence of this increased value of their property is commonly given to the stockholders of the corporation by declaring a stock dividend.

A second method of financing expansions is by the sale of securities. When this method is employed, certain general rules should be kept clearly in mind. In the first place, yearly costs of capital should be kept down as much as possible. Business is conducted for the benefit of the owners, the stockholders, and thus funds for expansions should be raised with a view to keeping down costs of providing these funds. That is why it is advisable for companies to issue bonds whenever possible, rather

than stocks, since the interest rates on bonds may be lower than the estimated increased earnings, and thus a larger margin of profits is made available for dividends to stockholders.

Not all industrial properties possess sound security for a bond issue. When earnings in a business vary greatly from year to year, it may not be possible at all times to meet fixed interest charges. If a company is unable to meet its fixed charges, it may lose possession of its property. Stockholders, of course, do not want to lose their control, and, therefore, should not approve a policy that would place too heavy a fixed charge on the company's earnings. It has become a rule in well-financed companies with fairly stable earnings, not to issue new bonds, except to an amount that will leave a wide margin of safety between net earnings and fixed charges. If net earnings over a number of years, or, perhaps, in the poorest business year during the past 5 years, have been two or three times the amount of fixed charges on present debts, including the new bond issue now proposed for expansion, this may be considered a fairly safe margin. Unless a safe margin exists between net earnings and debt charges, it is unwise to finance expansion by borrowing money. It may be possible to keep down the cost by borrowing, but the result of a policy of borrowing may, in the long run, prove ruinous to the business.

Moreover, if the business is one the assets of which decrease in value from year to year, provision must be made to set aside a fund, out of earnings, to replace the capital as it wears out, or is depleted. Unless this is done, the creditors of the corporation may find their investment slowly vanishing until, finally, the security of their principal disappears. The requirements for sinking fund are an additional fixed charge on the earnings of the corporation and must be taken into consideration before determining on financing expansions by the issue of bonds.

In the third place, the financial manager should issue new securities with a view to keeping control over the affairs of the corporation. If stock is issued to stockholders of record, in proportion to their present holdings; that is, if the stock allotment is made, relative control will not usually be affected unless a large amount of the subscription rights were to be sold to out-

siders desiring to get control. If, for example, the funds needed for expansion are too large for the holders of the stock to supply, they may sell a large part of their rights, and thereby give outsiders a chance to get control of the business.

To avoid this possibility, some companies have financed expansions by issuing stocks without voting power. The average small investor does not, ordinarily, attach much importance to the right to vote for directors of the corporation. He does not even take the time to sign and return his proxy to the secretary of the corporation so that someone else can vote his shares of stock. Proxies, or powers of attorney, to vote one's shares of stock at the stockholders' meetings, are commonly ignored by small investors in the stock of corporations. The voting power attached to shares of stock in a company that has been paying a regular rate of dividend over a series of years, is meaningless to the small investor, who merely wants a uniform return on his investment, with security of principal. But from the viewpoint of the financial management of the corporation, the question of keeping control is often of decided importance. Managers and directors of large growing businesses develop programs for expansion and growth for a number of years ahead and are, therefore, not anxious to have some other group obtain control with a view, possibly, to adopting another business policy. Nor are they willing to lose the salaries and emoluments incidental to their positions. Often it is for this reason that corporations issue stocks and bonds that have no voting power.

Finally, financial managers should keep themselves well informed on general business conditions before deciding on the advisability of enlarging an enterprise. There are certain recognized up and down movements in business activities commonly referred to as business cycles. These movements are reflected in periods of rising and falling prices. The financial manager of a business will have to answer the question "Shall funds be raised for expansion when it is easiest to obtain them, or shall they be raised when they are needed?" Many a business man believes that the best time to raise funds and to expand his concern is when business is booming and when every one is spending freely. Perhaps prices are rising rapidly, and

have been doing so for a long time. Profits have been large, and more business will apparently mean still larger profits. The sagacious business man, however, who has studied cyclical movements in the past, will realize that prices cannot keep on moving upwards indefinitely. Perhaps he does not want to see them keep on rising. He knows that, sooner or later, they will have to decline. People will stop buying when prices get too high to suit them. Then comes the period of forced sales, falling prices, and taking of losses. The business that does not have its shelves loaded down with goods at such a time, can consider itself fortunate. On the other hand, a business that finances extensive expansions just before the downward movement of prices begins, hoping to increase the profits by larger volumes of output, will find itself in difficulties. The wise enterpriser will, therefore, plan for expansion in a period of industrial depression when new sales plans can be made, when there is time for studying costs with a view to lowering them as much as possible in order to keep on producing and building up inventory in expectation of rising prices. In a period of depression, banks will have plenty of funds to loan, and will lower their rates of interest to encourage borrowing. Prices will be low and contracts for building construction can be made at relatively low figures by the shrewd business manager. At such a time, therefore, it is most advisable to plan and study industrial expansions carefully. Then, when business activities begin again, as they will, sooner or later, when accumulated supplies have been used up, such a company will be in a sound position to profit from a wise policy of expansion.

At the beginning of a long period of business decline, it would be unwise to sell high interest bearing long-term bonds to provide funds for expansion, for as time goes on, earnings may tend to fall off and therefore the margin between net earnings and fixed charges will gradually grow smaller and smaller. If, therefore, a business must finance expansion at such a time it should do so by issuing short-term notes. If this is inexpedient it should make its bonds callable at a slight premium at different intervals, so that they may be converted into long-term bonds later when the low point in the depression has been reached and

when funds can be obtained at a lower rate of interest. If this procedure is impossible, the corporation may issue stock rather than bonds at such a time, for the income on this stock will depend on the earnings of the corporation. By this process the company can keep down its fixed charges.

The rule that it is advisable to issue bonds, if possible, in a period of depression to finance expansions, and stocks in a period of prosperity, if it is necessary that expansions should be made then, has been criticized on the ground that it tells you what to do but it does not tell you when to do it. But the financial manager of a business is not left altogether in the dark. In the first place, he can obtain information as to the general movements of prices by consulting indexes of prices published periodically by a number of private agencies, as well as by the Department of Labor in Washington. An index number is a comparison of the general level of prices of a group of products with the level of prices of these products at another time, called the base. If, for example, the level of prices for a selected group of commodities in 1913 was 100 and in 1920 was 257, this would mean that the level of prices of these products has risen 15 per cent. from 1913 to 1920. Some index numbers are published weekly, others monthly, and so the alert business man has a chance to see from time to time the trend of the level of prices. In this way he can be guided in his judgment as to the advisability of making expansions to his business, in one way or another. Secondly, the business manager can consult investment bankers and credit officials of commercial banks, who keep informed, more or less, on general business conditions and who, on the basis of their experience and observations will at times venture to forecast what is going to be the trend of business conditions in the future. A number of the large commercial banks of the country have adopted the practice of publishing monthly or quarterly bulletins giving a survey of current business conditions. These bulletins are distributed free of charge to their customers and depositors and frequently contain much valuable information, carefully arranged, and analyzed by financial experts. Such bulletins as the *Survey of Economic Conditions,* published by the National City Bank of New York; *The Chase*

Economic Bulletin, published by the Chase National Bank of New York; the bulletins of the individual Federal Reserve banks, as well as the *Federal Reserve Bulletin,* published in Washington, should be consulted by every progressive business man. An interesting bulletin is published quarterly by the Continental and Commercial Bank of Chicago, entitled *The Trend of Business,* which contains much valuable information conveniently arranged and carefully analyzed. On the first and last pages of this four-page leaflet is a summary statement of the general business conditions in the country, and pages two and three contain the statistical data on which the conclusions are based. The statistics include tables of general price levels, money rates, stock-exchange quotations, bank discounts, total bank deposits, business failures, agricultural and industrial production, new building, employment, imports and exports, and opposite each set of statistics are brief interpretative statements. Thus, for example, opposite the general price level statistics appears the statement "continued increase," opposite "money rates," "continued ease." Opposite "bank deposits," "plentiful money" and so on. Such condensed statement of the trend of business is welcomed by all active business men who want to keep in touch with the conditions in the industrial world about them, in order, thereby, to be better able to gauge their own affairs.

Although it is impossible to predict exactly what is going to happen because of the many influences that are at work in our complex economic world, at all events the guess of the student of industrial conditions, in general, is more likely to be right if based on careful study and observation than if based on no knowledge at all. The business man or financial manager of a corporation who fails to keep an eye on general economic conditions, studying carefully the information that he can obtain and consulting those who have made a special study of business forecasting, may sooner or later find himself in difficulty. A broader and better knowledge of general industrial conditions will not only result in greater wisdom being shown in financing expansions of business enterprises, but will also do away with much waste in industry due to misdirected production.

FINANCE AND INVESTMENT

(PART 4)

Serial 2253D Edition 1

EXAMINATION QUESTIONS

Notice to Students.—*Study the Instruction Paper thoroughly before you attempt to answer these questions.* **Read each question carefully and be sure you understand it;** *then write the best answer you can. When your answers are completed, examine them closely and correct all the errors you can find; then mail your work to us.*

(1) (*a*) What are dividends? (*b*) When may they be declared?

(2) (*a*) What is surplus? (*b*) What are reserves?

(3) Name a few common kinds of dividends and briefly define each.

(4) (*a*) If a dividend is declared, who determines the rate or the amount? (*b*) On what is the rate or the amount based?

(5) (*a*) What are budgets? (*b*) What are their advantages?

(6) What are undivided profits, and where are they likely to be found?

(7) (*a*) What is often the reason for declaring stock dividends? (*b*) What special reason causes so many large stock dividends in recent years?

(8) Name a few forms of taxes and briefly explain each.

(9) Discuss a few ways of converting corporate debts.

(10) Explain what is meant by each of the following: (*a*) merger; (*b*) holding company; (*c*) vertical combination; (*d*) horizontal combination.

Mail your work on this lesson as soon as you have finished it and looked it over carefully. DO NOT HOLD IT until another lesson is ready.

FINANCE AND INVESTMENT
(PART 5)

CONSOLIDATION OF CORPORATIONS

TYPES OF CONSOLIDATIONS

1. Vertical and Horizontal Consolidations.—Consolidation of corporations makes possible the expansion of a business organization without the necessity of providing funds for construction or purchase.

One or more of several advantages are frequently expected to accrue from consolidation, according to whether the consolidation is a vertical or a horizontal one.

Vertical consolidations are frequently effected with a view to economies in production by putting all or most of the stages of production from the producing of the raw materials to the finishing of the product under a single management. The vertical consolidation, however, may merely be designed by a manufacturing interest that wishes to command its own source of raw materials. Rubber goods manufacturers, for example, may wish to own rubber plantations and get crude rubber at cost of production, thus avoiding the effects of price increases due to artificial restriction of production on the part of independent planters, and eliminating middleman's profit taking. Or a manufacturer may, on the other hand, wish to control a market for his finished goods. Candy manufacturing interests may control a chain of retail candy stores upon which it depends for the purchase of the product of its factories.

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Horizontal combinations are invariably designed to abolish competition between the formerly competing companies and thus to effect economies in production and distribution. Such combinations may be made to include as many as possible of the companies producing or distributing a given line of goods or services, with a view to the creation of a monopoly and the increase of profits by control of prices.

2. Mergers.—Consolidations may be effected by any of three methods. The first is that of the merger. With the method of merger one or more companies lose their corporate identity and the assets of the several companies are merged in the assets of the absorbing or consolidated company. Agreements are entered into preliminary to the dissolution of the companies that are to be dissolved, whereby the stockholders of the dissolved companies receive cash, stock, or bonds of the consolidated company for their holdings. The creditors of the dissolved companies become creditors of the consolidated company.

After the number of stockholders required by statute sign written consents to the proposed consolidation, a disgruntled minority may protest against being forced into the consolidation, but they cannot prevent it. If they wish, however, they may apply to the courts for an appraisal of the money value of their stock, which value the consolidated company is obliged to pay them in the purchase of their holdings. Sometimes, of course, private arrangements are made with such stockholders.

The method of merger is seldom used. There is generally something to be lost in wiping out the corporate existence of the consolidating companies. One company may possess in connection with its name, a trade reputation, or good-will, which, although intangible, may be an asset worth millions of dollars. Another company may hold certain franchises or other privileges that might be lost in the process of consolidation if the method of merger were used and the corporate existence of the company end, merely its assets being taken over in the consolidation, franchise rights, if non-transferable, being lost.

The two methods of consolidation most generally used are: first, the purchasing of stock control of one or more companies by another; and, second, consolidation by lease. With these methods, while the properties of the consolidated companies are operated effectively by one management, the good-will and privileges of all the consolidated corporations are retained.

3. Leases.—A lease is an instrument giving to a tenant or lessee the right to possession of property in exchange for rent to be paid to the landlord or lessor.

A corporate lease may turn over to the lessee all sorts of tangible and intangible assets. The corporate lessee in return may agree to pay as rent either a flat annual sum, or a proportion of the lessee's net annual earnings, or a stipulated rate of dividends on the lessor's stock, which dividends are, in practice, usually paid directly to the lessor's stockholders by the lessee. The lessee, under the terms of a corporate lease, almost invariably agrees, also, to pay all taxes, insurance, interest, and expenses of maintaining the organization of the lessor company and its property. Finally, the lessee may agree to pay the interest on the lessor's bonds.

Extra guarantees may be given to assure the payment of the stipulated rental. The Georgia Railroad and Banking Company, for example, has leased for 99 years, to the Louisville and Nashville Railroad and the Atlantic Coast Line, for a flat sum of $600,000 a year, its 303 miles of railroad. To secure the lessor, the lessee has deposited various bonds of an aggregate par value of $1,075,000 with a trustee, the Farmers' Loan and Trust Company. Under a lease made in 1901, for 999 years, between the Pittsburgh, Bessemer and Lake Erie Railroad Company, and lessee, the lessee agrees to pay the interest on the lessor's bonds, 6 per cent. dividends on the lessor's preferred stock, and 3 per cent. on the common. These payments are guaranteed by the Carnegie Steel Company, which controls the lessee through stock ownership.

Corporate leases provide, in the greatest detail, for the maintenance of the property by the lessor. Such provisions are more important in the case of relatively short-term leases than

when, for example, 99-year leases are made. If the maintenance of leased property is not carefully provided for in the lease, as the date of the expiration of the lease approaches, the lessee, unless he expects to renew the lease, will allow the property to deteriorate, making as much money as possible during the last year or two of his occupancy. The right may be reserved to the lessor to examine the physical condition of his property periodically, to see that the lessee is maintaining it according to the terms of the lease.

4. A typical provision for maintenance is the following, taken from the lease of the property of the Manhattan Railway Company to the Interborough Rapid Transit Company:

The lessee covenants and agrees, at its own proper cost and expense, to maintain, operate, and run the demised railroads and property during the said term in the same manner as the lessor is now or shall at any time hereafter be required or authorized by law to do; and shall and will keep all insurable property insured in reasonable amounts and rebuild all buildings and replace all property destroyed or deteriorated by fire or otherwise to such an extent as to be unfit for use; and shall and will maintain, preserve, and keep the railways and property hereby demised, including all property hereafter acquired, and every part thereof, in thorough repair, working order, and safe and efficient condition, and supplied with rolling stock and equipment, so that the business of the said demised railways shall be preserved, encouraged, and developed, the business thereof be done with safety and expedition, the public be accommodated in respect thereto, with all practicable convenience and facilities, and the future growth of such business as the same may arise or be reasonably anticipated be fully provided for and secured.

The lessee further covenants and agrees, at the expiration or termination of this lease for any cause, to return and deliver the said railroad and railroads, real estate, and properties by this lease demised, including, among other things, all property, additions, improvements, and equipments which shall be furnished, constructed, or completed out of the proceeds of sale of the stock, bonds, or property of the lessor, to the lessor in as good order, condition, and repair as they were at the date this lease takes effect, or at the date when the same came into the possession of the lessee, and to surrender said franchises, rights, and privileges, easements and properties unimpaired by any act of the lessee; excepting, however, all property of the lessor sold pursuant to the terms hereof, the proceeds of which shall have been applied as herein provided.

The lessee further covenants and agrees that it will, at all times during the continuance of this lease, at its own expense, keep the said rolling stock, and tools, equipment, machinery, and implements necessary for the operation of the road, in good order, condition, and repair, and will, as the same shall be worn out and rendered unserviceable, replace the same at its own expense, so that the said railroad and railroads shall always be kept, maintained and equipped in good and safe condition and effective working order.

The lessee further covenants and agrees that it will at all times during the continuance of this lease, at its own expense, comply with all lawful requirements with respect to the construction, maintenance, and operation of said railroads, extensions, or branches thereof.

5. In the lease of very large and complex properties, provision is usually made for the sale of any portion of the property which may have in time become useless to the lessee. It may be required, however, that the lessor's consent be obtained; and invariably it is required that the proceeds of the sale are to be invested in improvements of the lessor's property. A street railway, for example, operating leased properties, may be permitted to sell certain car barns no longer useful and expend the proceeds in the enlargement and improvement of terminal facilities.

In addition to the above provisions, a corporate lease contains *a description of the property* leased, usually in the form of a complete inventory, which must be kept up to date as the nature of the corporate property changes, and an agreement as to the length of the lease. Corporate leases are usually long-term leases; 99 years, frequently, and not unusually, 999 years.

Intercorporate leases have been used chiefly by railroads, and in that field they have presented certain distinct advantages. The chief of these is that consolidation by means of the lease of one railroad property by another secures the benefits of united operation without the financial cost involved in the outright purchase of a railroad property, or even of the controlling interest in the stock of the corporation owning the leased line. Consolidation by lease, therefore, is a simple method of consolidation that does not require the issuing of any securities nor the raising of funds.

The lessor as well as the lessee finds advantages in the lease method. The lease gives the stockholders of the lessor company a certain guaranty of a fixed return, and changes the nature of their claim from that of a stockholder to that of a creditor. Their claim is that of a debt against the lessee, which debt, if not paid, may result in the lessee's loss of the property. This debt is, in a sense, a fixed charge of the lessee.

6. The method of consolidation by lease, however, complicates the problem of financing improvements on the leased property. Under the law relating to leasehold interests, additions or improvements affixed to the property by the tenant may become the property of the landlord upon the expiration of the lease. If a lessee is sure of holding his property for 99 or 999 years—the terms of many corporate leases—he would have little hesitation about improving or bettering the property. But the lessee has the fear that he may run into hard times, be unable to pay the rental, and be obliged to give up before the expiration of the contract period, the property into which he may have sunk tremendous sums in improvements. Or suppose the lessor should hit upon some excuse for canceling the lease before the expiration of its life? The stockholders of the lessor company might, for example, allow their company to be thrown into the hands of a receiver, who might then cancel the lease as an undesirable contract inherited from the past management. The leasing road in such cases would be helpless to prevent the action, or even to collect damages from the receiver of the reorganized road.

Because of these possibilities of the instability of the lessee's hold on leased property, it has become the usual practice today to finance improvements by having the lessor pay for them, the lessor acquiring the necessary capital through the issuance of his own securities—bond or stock. The lessee then pays rent for the improvements by paying the interest on the lessor's bonds or the dividends on his additional issue of stock.

In recent leases it is frequently provided that the lessor company may be obliged, under certain conditions, to finance improvements upon its own property according to the equitable

plan explained above. An example is the agreement providing for this in the lease that gave to the Boston Elevated Railway Company control of the West End Street Railway. In this lease it was provided that improvements should be financed as follows: The lessee should decide what improvement might be required to maintain or increase the profitableness of the property. It then should ask the lessor's consent to the improvement and the issuance of stock or bonds of the lessor for the purpose of financing. In case the lessor fails to agree with the lessee as to the need or the expediency of the improvement and the issuance of its securities to meet the expense, an arbitral board decides the issue. One arbitrator is to be chosen by each of the parties to the lease, and the third by the two so chosen, or by the State Board of Railroad Commissioners, or by the Chief Justice of Massachusetts.

In case it is finally decided to go ahead with the improvement, the lessor has the right to say whether the securities to be issued shall be stock or bonds, or both, and to determine the rate of interest to be paid upon interest-bearing obligations issued against the improvement. Then the lessee is obligated, under terms expressed in the original agreement, to pay the dividends or interest upon the stock or bonds issued; and, if bonds are issued, an increase in rental, which will provide for the sinking fund on the new bonds.

Since some kinds of work on the leased property may properly be chargeable to operating expenses which the lessee would be obliged to pay without the right to call upon the lessor to finance, it is necessary to set down in detail in the lease exactly what property shall constitute permanent improvements, additions, etc., properly chargeable to capital, and therefore such as the lessor shall be required to finance. In the lease of the property of the West End Street Railway, these are especially limited to:

1. The abolition of grade crossings.
2. Additional rolling stock and equipment.
3. Additional track mileage and its equipment.
4. Additional real estate.
5. Additional stations, power, and car houses.

6. Additional buildings, bridges, and other structures.

7. Renewals of or substitutes for stations, bridges, buildings, and other structures, track and equipment, rolling stock and equipment, power houses and equipment, and car houses and equipment, so far as the cost of such renewals or substitutions exceeds the cost, when new, of the things renewed or the things replaced.

In addition to the difficulties attending the financing of improvements, the lease has other disadvantages, which sometimes outweigh its advantages, as a single method of consolidation. One of these which may be mentioned is the fact that the rent paid to the lessor, even if the lease provides that it is to be paid directly to the stockholders, is considered, under the Federal Income Tax Law, to be taxable profits on which tax must be paid. This tax could be avoided if a method of consolidation other than that by lease were employed.

7. Stock Control.—The third method of effecting consolidation is that of stock control. Very often stock control may merely be employed to reinforce the lease. For example, in order to prevent a move on the part of the stockholders of a leased line to allow their company to fall into the hands of a receiver, with a view to obtaining the cancelation of a lease, the lessee company will usually purchase at least a minority interest in the stock of the lessor corporation. If the leased line is of essential importance to the lessee's system, the lessee will invariably strive to obtain control of the stock of the lessor. And, on the other hand, stock control may be used merely as an aid to consolidation by lease. It may be advantageous or even necessary before a lease of certain properties, at least on terms the prospective lessee could consider satisfactory, for the prospective lessee first to obtain a controlling interest in the stock of the company owning the property. Then it not only can obtain a lease to the property on satisfactory terms, but can feel sure of not losing the leased property.

Stock control, however, is a means of consolidating that is used quite generally apart from any association with the lease,

and it effects a consolidation that is both theoretically and practically very different from that effected by the lease. Stock control involves the outright ownership, by one corporation, of sufficient of the voting stock of another to give the former absolute executive management of the latter. The control is permanent and absolute; the latter company is a subsidiary of the former and its policy is directed at all points by the parent company.

The amount of stock required for control varies with a number of circumstances. Ordinarily, a majority ownership of the voting stock is necessary. But frequently less than a majority interest is sufficient. This is due in part to the fact of negligence and indifference on the part of many scattered stockholders who do not vote and do not sign proxies. When a contest is on between two interests, both seeking control of the same company, a larger percentage of the voting stock will be actively drawn into the contest and a minority interest in the stock will not be likely to obtain control.

When the interests of the parent, or owning, company and the controlled, or subsidiary, company are likely to be at odds, the minority stockholders of the subsidiary may take legal steps to prevent the parent company from controlling the subsidiary in the interests of the parent. Many manufacturing companies have closed down or desired to close down badly located or otherwise unprofitable mills of their subsidiaries in order to concentrate production in plants of their own which have lower cost of production, because of better equipment or location or other reasons. This policy is directly opposed to the interest of the minority stockholders of the subsidiaries the mills of which are closed. These mills, with a higher cost of production than those of the parent company, may yet be able, with prevailing prices, to manufacture at a profit. They have nothing to gain by the concentration of production in more profitable mills that are owned by others than themselves. Where such conflict of interest may arise between a parent and a subsidiary company it is usually to obtain ownership of all of the stock of the subsidiary; if such is obtainable, there are then no minority stockholders to appeal to the courts, and

the creditors cannot interfere so long as fixed charges are regularly met.

If the interest of parent and subsidiary are diverse, and not all the minority stockholders of the latter can be persuaded to sell out, the minority may sometimes be satisfied with a guarantee by the parent company of a substantial dividend on the stock. In 1901 this method was followed by the Carnegie Steel Company. Since 1897, when the Pittsburgh, Bessemer & Lake Erie Railroad Company was organized, its principal freight has been ore destined for the Carnegie furnaces. A minority of the stockholders of the railroad claims that the railroad stock was not paying dividends because a majority of the stock was held in the interests of the Steel Company and that the Steel Company was able to set rates entirely too low on the ore carried to its furnaces. To quiet this criticism the Carnegie Steel Company, through its subsidiary, the Bessemer & Lake Erie, guaranteed a dividend on the stock, leaving itself free to fix rates to suit itself.

8. Three important methods are open to a company desiring to obtain control of the stock of another. First, it may purchase outright, for cash, privately or on the exchange, stock from the shareholders of the other company. This is the simplest method.

A second method is by the exchange of stock for stock. The stockholders of the prospective subsidiary are offered stock of the purchasing company in exchange for stock in their company. This method has the advantage over outright purchase in that it requires no direct money expenditure, and therefore no use of financial expedients designed to get cash. On the other hand, it may be necessary for the purchasing company to make a particularly favorable offer to the shareholders of the other company in order to induce them to surrender control of their property; and, considering the relative market values of stock exchanged, the method may prove to be very expensive. On the other hand, the stockholders of the prospective subsidiary may readily exchange their stock at a ratio favorable to the buyers. Often the advantage, in railroad consolida-

tions, for example, of securing a stock of greater marketability is quite effective in leading the shareholders of a small local road to exchange their stock for that of a larger road whose securities are more widely known; and in some cases the prosperity of the small road is so dependent upon its relations with the large road that the shareholders of the former feel that their investment is better protected when made an integral part of the consolidated system.

Thirdly, the exchange may be of collateral trust bonds of the purchasing company for the stock of the other company. By using this plan the purchaser substitutes credit for money in the acquisition. The bonds offered are secured by the deposit of the stock acquired as well as by the general credit of the borrower.

The stockholders who part with their stock are assured of stipulated returns on their investment, and still have a lien on the stock deposited as collateral. Moreover, the stockholders who exchange stock for bonds possess securities that represent a direct obligation of the purchasing company, an obligation that ranks ahead of the stockholders' claim on earnings of the company.

9. A fourth method sometimes used is for the purchasing company to issue stock trust certificates, on which it guarantees dividends. In 1909, for example, the Minneapolis, St. Paul & Sault Ste. Marie Railway Company acquired most of the preferred stock of the Wisconsin Central with its leased lines stock certificates secured by a deposit of the acquired stock. These certificates were guaranteed a dividend of 4 per cent. for 99 years.

These stock trust certificates do not materially differ from the collateral trust bond. In case of default in payment of the guaranteed dividend, the holders of the certificates receive back their stock from the trustee, and may sue for unpaid dividends. However, the obligation of the certificate is not a direct obligation of the company, like the obligation represented by collateral trust bonds, but merely a contingent obligation. The use of the stock trust certificate may be considered a com-

promise between the use of bonds and the use of stock, in the acquisition of the stock of another company.

In the process of acquiring stock of one company on the part of another, there comes into play in the planning of the method to be used and in the bargaining, both the point of view of the purchasing company, and the point of view of the individual stockholder who is asked to surrender his stock. If the purchasing company has a substantial surplus over its regular disbursements, it can safely offer either bonds or their cash equivalent to the holders of the stock it wishes to acquire. Other things being equal an offer of bonds will be desirable. If the stock desired is a dividend payer, a substantial portion of the interest on the collateral trust bonds offered in exchange for it may be provided out of the dividends paid on the stock deposited as collateral. There may further be the likelihood that the stock acquired will increase in value after the consolidation. By offering bonds instead of stock the purchasing company may induce the sellers to surrender their right to share in increase of profits in exchange for a secured claim to the interest on the bonds they accept.

Some of these purchases of stock with bonds have been immensely profitable to the purchasing companies. In 1898, for example, the New York Central purchased $45,000,000 out of the $50,000,000 capital stock of the Lake Shore, Michigan & Southern. In exchange it gave its 3½ per cent. bonds at the rate of $200 in bonds for $100 in stock. The Lake Shore stock paid 7 per cent. dividends; these dividends on the stock deposited as collateral therefore were sufficient to pay the interest on the bonds. There was, consequently, no impairment of the purchasing company's credit.

From 1899 to 1903 the Lake Shore paid this 7 per cent. dividend; from 1904 to 1906, inclusive, it paid 8 per cent. In 1907 it paid 12 per cent.; in 1918, 14 per cent.; and in 1909, 12 per cent. This profitable exchange was fortunate for the New York Central, for had it not been for the profits from the increased dividends of the Lake Shore stock it owned, it would not, in 1909, have been able to maintain the 5 per cent. dividends on its own stock.

However, a purchasing company must hesitate in offering its bonds in exchange for stock of another company if there exists any doubt of its ability to meet the interest on a bond issue sufficient to acquire the stock desired. So long as the earnings of the subsidiary whose stock is acquired permit of a dividend sufficient to carry the interest on the collateral trust bonds, the plan works well, and, as has already been shown, may be extremely profitable to the purchaser. But if earnings of the subsidiaries fall, and the parent company should have pyramided its credit by issues of collateral trust bonds, bankruptcy for the parent company will be the result. Earnings fluctuate and future earnings of to-be-acquired subsidiaries may be difficult to estimate. Nevertheless the collateral trust bond has been, and still is, very extensively used as the simplest and distinctly the cheapest means of consolidation by stock control.

When it is deemed unsafe, however, by a purchasing company to increase its bonded indebtedness in the process of acquiring the desired stock, cumulative preferred stock instead of bonds may be offered to the stockholders of the prospective subsidiary. As a compensation for the acceptance of the contingent rather than a direct claim on earnings, they will receive the higher yield that the stock will have, as compared with bonds, and the purchasing company will not be thrown into the hands of a receiver if it is at any time unable to meet the contingent liability represented by dividends due on the preferred stock.

The acceptance of the offer is never certain, regardless of what form of consideration may be offered for the desired stock. There will inevitably be some stockholders who will refuse to sell; others who will accept nothing in exchange but cash. Consequently, as may be expected, in such deals we find the investment banker called in. An underwriting syndicate is formed to guarantee the provision of whatever cash may be needed, and it may even guarantee the delivery of the requisite stock.

The syndicate will usually make its offer to the holders of the desired stock contingent upon the acceptance of their offer by the percentage necessary if the syndicate is to be able to carry out the plan of stock control.

THE HOLDING COMPANY

10. Purpose and Plan.—The holding company is a corporation organized for the purpose of acquiring and holding the stocks and other securities of other corporations. These securities are acquired by the holding company by the use of one or more of the methods described in considering the problem of consolidation by the method of stock control.

The holding company may itself be also an operating company, holding the stock of other operating companies; it is the parent company, and the others are its subsidiaries. The most distinctive type of holding company, however, is one which is not itself an operating company, but merely exists as a means of bringing under a single control the management of the various operating companies that it controls. This type of holding company may possess no property of any kind except the securities of subsidiaries owned by it. To obtain and keep control of its subsidiaries it need not buy up all their securities; it need only hold a controlling interest in the voting stock of each subsidiary. The board of directors of the holding company, through its control of the voting stock of the subsidiaries, elects a controlling majority of the board of directors of each subsidiary, and completely dominates its policy.

There are certain advantages which are peculiar to this system of corporate stockholding, and which it is hoped to take advantage of in the formation of the holding company. Sometimes a state will provide by statute that no foreign corporation may hold real estate within its borders. If a corporation organized in one of the popular incorporating states, such as Delaware or New Jersey, wishes to own property in one of the stricter states, it can do so only by organizing or acquiring control of a subsidiary corporation in the other state or states. Second, where a large part of a company's business is localized it may prove advantageous to incorporate that part of the business separately. In this way local representatives can be placed on the board of directors and through their local connections and influence the company may avoid much of the criticism that might be directed against it as a foreign corporation.

Then, there is the consideration that the subsidiary company is a means whereby the liability of the parent or holding company is limited, although the parent company may act as a guarantor of the securities of the subsidiary. Whether a new enterprise shall be launched through a subsidiary corporation or merely maintained as a department of the parent company, is a question frequently raised. The credit and reputation of the parent company may be the very thing necessary to give the enterprise a successful start. But if the new undertaking is hazardous, it may be wise to undertake it through a subsidiary corporation. Then, although the investment in the subsidiary may be lost, the parent company may turn the subsidiary loose without becoming additionally involved in its affairs. If the subsidiary has been acquired by the use of collateral trust bonds, as described under consolidation by stock control, the loss may be very slight indeed.

Sometimes, when the stockholders of a company whose property another company may wish to obtain control of, would be likely to make extravagant demands for rentals and hold out stubbornly, the holding company, instead of asking for a lease, may be able to go out and quietly pick up enough stock to control the other company. Some banking houses make a specialty of collecting stock for control.

Very frequently subsidiaries are used to hide trade secrets, or to handle an inferior line of product which might be in itself profitable, yet which the parent company, its good-will dependent on the association of its name with a superior line of goods, will not wish to associate directly with its corporate name. Or a subsidiary may be employed to prosecute a line of business which the parent company, under the limitations of its charter, may not be permitted to enter.

11. The General Motors Corporation used the following plan when it was expedient to organize a subsidiary company rather than to issue manager's stock. The plan was described in a letter of the President, A. P. Sloan, as follows:

The plan involving the formation of the Managers' Securities Company is designed to interest the men occupying important managerial positions as partners with the stockholders in this corporation.

In a great structure such as the General Motors, where our problems and our operations are so diversified, where capital must be employed and plants operated in the best interests of the corporation as a whole, as against any separate part or division, and where new capital supplies should be injected where they will accomplish the greatest good, it is important to find, develop, and retain men to occupy important managerial positions who are capable of assuming great authority and the responsibilities that make these positions important. Not only is it necessary that these managers be capable of handling efficiently the immediate problems of their respective positions and divisions, but it is essential that they view broadly and understand the policies necessary to coordinate the various ramifications of this vast business and thus secure proper return to the stockholders on upwards of $500,000,000 of capital employed.

There are approximately 70 managerial positions upon the occupance of which the corporation must rely for the successful management of its business. From practical experience and observation directors believe that the men occupying these positions can secure a better, broader, and more sympathetic understanding of the stockholders' interests, and, therefore, of the interests of the corporation as a whole if they can be attracted into partnership with the stockholders through becoming substantial stockholders themselves. The plan below is calculated to supply all of the above and may be briefly summarized as follows:

(1) General Motors Corporation will cause the Managers' Securities Company to be organized in Delaware with a capital of $28,800,000 of 7 per cent. cumulative non-voting convertible preferred stock, $4,000,000 of Class A stock and $1,000,000 of Class B stock.

(2) General Motors Corporation will subscribe for all of the Class A and Class B stock, paying therefor $5,000,000 in cash, and will enter into a contract with the Managers' Securities Company, agreeing to pay to it for each year from 1920 to 1930, both inclusive, 5 per cent. of its net earnings of 7 per cent. on the capital employed. On January 1 of each year it will advance $2,000,000 to the Managers' Securities Company on account of amount due under this contract, or as a loan, or both, as more fully recited in the plan.

(3) The Managers' Securities Company will offer to purchase as of October 15, 1923, the equivalent of 2,250,000 shares of General Motors Corporation Common Stock at $15 per share, aggregating a total purchase price of $33,750,000, payable $4,950,000 in cash and $28,800,000 in its 7 per cent. cumulative, non-voting convertible preferred stock; this is at the rate of $220 in cash and $12.80 in 7 per cent. preferred stock for each share of General Motors Corporation Common Stock purchased.

(4) A special committee of the directors will select a list of managers (including directors who are occupying managerial posi-

tions) to whom the General Motors Corporation will sell at cost the Class A and Class B stocks of the Managers' Securities Company theretofore purchased. Sales so made to these managers will be secured by an agreement under which the General Motors Corporation shall have the right to repurchase said stock under the terms and conditions recited in the plan.

12. Expedients such as this, and that of management stock designed to give the management particular inducements to efficiency, may be compared with the expedient of employe ownership, designed to stimulate the labor force to greater efficiency, and of customer ownership, designed to win the customer's favor and interest in the continued welfare of the business.

The holding company plan of consolidation, however, is not without its disadvantages. In the holding company plan there is the burdensome and expensive duplication of accounts, of offices, of executive meetings, and of taxes. The holding company plan may involve a scattering of effort, especially in the marketing field, and the good-will attached to the corporate name of the parent company may not be reflected in the value of the sales and prices, and in the stock, of the subsidiary.

The advantages of the holding company plan so frequently outweigh the disadvantages, however, that it is a very generally adopted plan of consolidation.

The holding company plan has been notably successful in the public utilities field. In this field the holding company form of organization represents a means which gives concentrated financial and operating control over small independent public utilities that may be geographically widely separated.

It is alleged, and is generally a fact, that the superior technical efficiency of a centralized management, as compared with a local management, makes for greater efficiency. By reason of its ownership of a number of utilities, the public utility holding company is able to employ a general manager of far greater technical knowledge and business acumen than the meager resources of the single local utility can command. The ordinary, humdrum details of operation may be left in the hands of the local managers, but technical policies for all the

local utilities are determined by a corps of high-salaried, trained engineers under the employ of the holding company. The public utilities holding company, moreover, makes possible considerable economy in the purchase of equipment. The central purchasing department of the holding company, upon which requisitions are made by the local managers, is able to use better discrimination in selecting machinery and equipment than the managers of a local company when acting alone. Purchases can be made in greater quantities and economies effected in this way also. Matters of business policy concerning rate determination, the placing of contracts, the making of extensions for new customers, the meeting of competition, are best cited not by a local manager of limited experience but by the highly trained and widely experienced experts which only the holding company can afford to employ. Finally, the holding company is able in critical moments to render financial support to the local utility company, in the marketing of its securities, in affording it credit, and so on.

13. The Finance Holding Company.—Some holding companies in the public utility and other fields are organized not primarily to effect a unification of management—management companies—but for the purpose of financing subsidiaries. This latter type of holding company is usually referred to as the finance holding company. These finance holding companies are usually themselves subsidiaries of some great equipment manufacturing company. The object in the organization of the finance holding company by the manufacturing company, is that the former may be used to assist the latter in pushing its business.

The great companies manufacturing electrical appliances have thus placed themselves, by means of the organization of finance holding companies, in a position to render assistance to new companies that will afford a market for electrical appliances. The General Electric Company owns all the capital stock of the Electrical Securities Corporation and of the Electric Bond & Share Company. Both of these subsidiaries are finance holding companies. They take part in the underwriting of

securities of electric companies of various kinds and purchase, also, the bonds of such companies, taking sometimes along with the bonds, a bonus of stock. They finance their operations not only through the excellent credit which the backing of the General Electric Company gives them, but by the deposit of the securities they acquire as collateral for their own collateral trust bonds. For example, the Electrical Securities Corporation in 1904 offered $500,000 out of $1,000,000 collateral trust 5 per cent. bonds secured by $1,250,000 par value of first mortgage bonds of nine electric railway, power, and traction companies located in different parts of the United States.

This is an example of mixed collateral behind collateral trust bonds. By having securities of various companies in the collateral, the possibility of decrease in the value of the securities of one company is offset by the possibility of increase in the value of the securities of another; whereas, the fact that the industries whose securities are represented are of somewhat different natures, and are geographically wide apart, decreases the likelihood that their securities might all depreciate together. In this case, however, the Electrical Securities Company was required to keep the principal acquired out of its interest-paying bonds under pledge, equal at all times to at least 125 per cent. of the principal of its collateral trust bonds outstanding; in this case, again, the nine companies whose securities were pledged, all prospered and earned a surplus over fixed charges.

In such operations by a finance company, through pledging the securities of the companies it promotes or assists as collateral for long-term loans, it is enabled to free its capital for new employment, without the necessity of selling the unseasoned securities at low prices. When the securities increase in value, some or all of them may be marketed, and the finance companies own collateral trust bonds paid off by the proceeds.

The object of the Electrical Securities Corporation and the Bond & Share Company is primarily to assist the General Electric Company in pushing its sales. It is not their object to act permanently as managing holding companies, retaining the securities they acquire for purposes of control. Instead, as fast as the acquired securities show a substantial profit—indi-

cating that the subsidiary is on its feet—they are sold, and the proceeds used for further financing in new fields.

14. The Investment Company.—The finance holding company is somewhat similar to the investment trust, or investment company, which has been for many years popular in Great Britain and Holland and is becoming increasingly popular in the United States. An investment company is a corporation, or may be, as is frequently the case, a Massachusetts trust, which purchases the securities of other corporations, but not with a view to obtaining control or undertaking operation or administrative duties. The investment company was first developed in England and Holland, where there is a great deal of investment in foreign fields. Its object was to consolidate the efforts of people seeking to invest abroad. Two major advantages are claimed for such corporations: first, they diversify risk; second, by accumulating tremendous resources under unified control, they can make their investment in any given enterprise large enough to warrant the large expenses that are sometimes necessary, under a receivership, for example, to protect the original investment. The investment company relieves the general investor of the necessity for seeking out for himself safe and profitable investments for his money.

For example, the International Securities Trust of America, organized as a Massachusetts Trust, described its business as follows:

> The business of the International Securities Trust of America is solely the investment of capital. Its operations are controlled by regulations and restrictions set forth in the declaration of trust. All fundamental investment factors, such as diversification of investment, selection of investments, maintenance of safety standards among investments, regulation of issues, maintenance of reserves, maintenance of equities, etc., are provided for by specific regulations . . . When the resources of the Trust are $1,000,000 or more, the Trust may not place an average of more than one-fourth of one per cent. of these resources in any one investment. As a result, the assets of the Trust will represent at least four hundred different investments. The Declaration of Trust provides that no funds may be invested in new or unproved securities, that the Trust shall not engage in promotion or business management, and may not acquire

or hold a majority in any enterprise. The Trust selects its own investments through its statistical department, all those below certain standards being eliminated. Investments once purchased must be disposed of if they fall below the standard specified. As a result, nothing but seasoned collateral can be purchased and held.

Against these assets this Trust issues its own secured serial bonds and preferred and common shares. These preferred shares are preferred as to assets, and it is provided that the issuance of preferred shares be restricted so that the assets of the Trust taken at cost price will be equal to at least 133 per cent. of the par value of the preferred shares outstanding. Moreover, it is provided that there be maintained a dividend reserve equal to ten times the annual dividend of the preferred stock. British investment trusts usually issue debenture bonds against its assets, debentures being more popular in England than in the United States, where the investor generally prefers specific security behind the bond.

The Investment Trust described above is of the pure and simple type which never acts in the capacity of manager holding company, or of the finance holding company.

Another example in a non-industrial field is the Mortgage Bond Company of New York. This is a corporation. It owns first mortgages in a large number of cities, and from time to time issues bonds secured by these mortgages with the proceeds of which it purchases other mortgages, which will in turn be pledged as collateral for further issues of bonds, and so on, pyramiding credit.

The bonds of this company must at all times be secured by deposit, with a trustee of first mortgages, equal in face value to the value of the bonds outstanding on improved real estate in cities with a population of not less than 40,000 each, subject to the right of the company temporarily to deposit cash, government bonds, or New York City bonds, at a valuation of 5 per cent. below the market value thereof. All the mortgages used as collateral are limited to one-half the value of the mortgaged property as appraised by the company. For property in cities having a population of 300,000 or over, such mortgages may equal three-fifths the value of the property, and in New York City,

two-thirds of the value. These bonds are issued at low rates of interest and their proceeds can be loaned at rates that show a substantial margin of profit for the stock of the company. The mortgage bond indebtedness of the company is limited to fifteen times the capital stock outstanding at the time of issue.

15. But many investment companies on occasion, when it appears expedient or profitable to do so, broaden their field of operation. In some cases, new flotations get their capital from investment trusts. Such a trust may act as an underwriter in taking over, at very low prices, the stocks and bonds of new corporations in which it has confidence, receiving occasional bonuses of stock, and selling its own shares or debentures on an investment basis. This fundamentally is the same plan as that followed by railroad companies which build branch lines through the employment of subsidiary companies, and then sell the securities of these companies in the form of their own collateral trust bonds to the public.

In thus acting as an underwriter of new flotations the investment company has a distinct advantage over the investment banker. The banker is compelled to turn his capital over quickly. Therefore, in order to market immediately the securities purchased, he is forced to offer them at lower prices than he might obtain if he could afford to hold them until the issuing company had fully demonstrated its earning power. But the investment company, as is the case with the finance holding company, whenever it too undertakes to underwrite new flotations, is able to retain its purchases until they increase in value as a result of demonstrated increased earning power of the issuing company, and, if it chooses, eventually dispose of them at a good price when they have substantially appreciated in value. The investment company and the finance holding company have this opportunity to profit not possessed by the investment banker, because they are able to issue their own long-term debentures or collateral trust bonds, as the case may be, against the purchased securities. The investment banker, it is true, sometimes may be forced to carry a stock of securities that

he has bought and cannot sell. He may then borrow with these securities as collateral for the loan. But he borrows from the commercial banker and aims to dispose of the collateral as quickly as possible and repay the loan. An investment banking house with a capital of $500,000 is a very substantial one; therefore, such houses cannot afford to tie up their credit if they are to continue actively to do business.

16. Pools.—The holding company of today has grown up, to some extent, to be used for the purpose of surmounting legal restrictions on other forms of consolidating competing enterprises. This fact may best be seen after noting some of these other attempts to accomplish the same object.

Before 1898 the pool was the usual device used to lessen unrestrained competition. A pool is a voluntary association of sellers who place the marketing of their product under some central control or general restriction. The primary object of such an agreement is to secure profitable prices, either directly or by means of payments from the central treasury to the members of the association. The methods by which these profitable prices were secured were generally either by restriction of output of factories included in the pool, so that by virtue of the decreased supply prices would be forced up, or, secondly, by holding the buyer to regular quotations; all members of the pool refusing to sell below certain prices, and thereby making it impossible for the buyer to play one producer against another.

The pool may go further than the regulation of prices and output. It may secure favorable terms on materials purchased. It may deal as a unit with railroads in order to obtain such concessions as are granted to large shippers. It may assist its members in dealing with organized labor. As a rule, however, details of management are left to the separate associated companies; the central body confines itself to the regulation of production and the control of prices.

A central governing body is usually appointed, which conducts all routine business and receives and distributes the funds of the organization. But a meeting of all the members of

the pool, or of an executive committee made up of all the larger manufacturers included in it, is usually required to decide matters of such importance as change in prices. But in the Wire Nail Association, which held control of the nail market during 1895 and 1896, the central office fixed prices and assigned to each producer his share of the output, which output was limited to the quantity that it was thought could be sold at the price agreed upon. In such restriction of output the poorest equipped or poorest located plants, those with consequently high cost of production, might, just as in the case of modern consolidations, be shut down. With the pool type of organization, the owners of the idle plants would be paid a certain rental to keep their plants idle.

The Bessemer Steel Pool, organized in 1896, is a good example of a pool. It included a majority of the producers of crude steel and finished material in the central west. Every mill was given a percentage allotment which it was permitted to sell. At the end of each month the amounts of the shipments from all mills were reported to the officers of the pool. If any mill was found to have exceeded its percentage of the total production of the associated companies, it was required to pay into the pool treasury two dollars for each ton of excess production. The pool treasury, on the other hand, paid the same amount per ton to each company that shipped less than its allotted amount of steel.

The pool proved itself a weak and defective form of organization. It could not enforce its agreements. Any member could withdraw on short notice, and there was little mutual confidence. A slight suspicion or misunderstanding was likely to cause a stampede of disillusion, and the former competitors would again compete with one another. A business depression is something a pool is not likely to survive, for then business at profitable prices is hard to get and strong producers are likely to want to have free rein to sell as much as they can at the lowest profitable price, letting the weak go to the wall.

17. Trusts.—The trust, another early and more successful form of restriction of competition was very different in

form from a pool. The trust was created by the companies in agreement depositing their stocks with trustees, receiving in exchange trust certificates. The holders of these certificates elected the trustees and recovered the sums paid as dividends on the stocks deposited in trust. The trust certificates could be dealt in on the exchanges, just as are the voting trust certificates of today. The trustees of the trust, being in control of the stock of the several corporations included in the trust, elected and controlled the boards of directors of the several companies, and thereby was able to effect a uniform policy concerning prices and output. Permanence of control was secured by making the transfer of stock to the trustees irrevocable, except by the formal dissolution of the trust as provided for in the articles of association. As a revice for the restriction of unlimited competition, the trust was about as satisfactory as the modern holding company. But its legal position was seriously and inherently weak. The trust was not only liable to be prosecuted under laws—notably under the Sherman Antitrust Law of 1890—as a combination in restraint of trade, but because on entering a trust a corporation exceeds the powers of the charter.

In the case of the North Sugar Refining Company the court's decision included the statement that "the defendant had disabled itself from exercising its functions and employing its franchise as it was intended it should by the act under which it was incorporated, and had, by the action which was taken, placed itself in complete insubordination to another and different organization (the trust) to be used for an unlawful purpose, detrimental and injurious to the public." This was a subversion of the object for which the company was created, and it authorized the Attorney-General to maintain and prosecute this action to vacate and annul its charter. Even without the Federal Antitrust Law, therefore, the legal position of the trusts appeared in time to be impossible. The various states had prohibited all combinations in restraint of trade, and each state could revoke the charter of any corporation that it had chartered, if the corporation exceeded the powers of the charter by subordinating itself to a trust organization.

18. Holding Company Operation.—The holding company arose to fill the need created by the failure of pools and trusts, to restrict unlimited competition. Before 1889, when the corporation law of New Jersey was revised, no state law authorized the chartering of a corporation for the general purpose of owning the stocks or property of other corporations. Such purpose was not considered to fall within the field of corporate privilege. Almost universally, it was the general rule that a corporation should be organized only for some specific line of production or distribution, or for very closely allied lines. The corporation laws of New Jersey, as revised in 1889, permitted the chartering of corporations to operate as holding companies.

Under the law, following the decisions against the American Sugar Refining Company of New York, in 1890, and the Standard Oil Company of Ohio, in 1892, the trusts proceeded to reorganize as holding companies under New Jersey charters.

The change in organization was relatively simple. The directors of the holding company took the place of the trustees of the trust, with power to control the policies and actions of the constituent companies. Shares in the holding company were issued in exchange for trust certificates, and the shareholders elected a board of directors, just as they formerly elected trustees. For all practical purposes the old-time trust and the modern holding company are identical.

Supreme Court decisions established the legality of the holding company as a form of organization. A holding company may, however, under the laws prohibiting undue restraint of trade, be ordered dissolved if in intent or effect it breaks the law. These unlawful practices are enumerated in the Clayton Law, as follows:

1. Price discrimination when the object is to create a monopoly.
2. Tying contracts, by which the sellers or lessors of goods attempt to prevent buyers or lessees from buying or leasing the goods of others, the object being to create a monopoly.
3. Prohibition against the ownership of stocks in competing corporations by a third corporation unless the purpose is for investment.

4. Prohibition on interlocking directorates in certain classes of corporations by which is meant the holding of directors' positions on two or more large banking institutions in large cities, or large corporations of any kind.

If business should be in need of such drastic regulation, the Federal Trade Commission is probably an improvement over the working of the Department of Justice in enforcing the Anti-trust Law. All of the orders of the Commission are subject to revision by the courts. The authority of the Commission, and the respect in which it is held, will depend upon the final disposition of its orders.

19. The study of holding companies completes the larger study of consolidations. There remain now some observations to be made not concerning the legal, but the more purely economic features of this aspect of corporation finance.

Many consolidations have been effected largely with a view to attaining what is usually referred to as large-scale production. Such large-scale production is held to enable an organization to put goods on the market more cheaply, and therefore obtain an advantage over competitors. It is considered that such large-scale production will effect economy by: first, purchasing and selling in larger quantities, the result being a saving in buying and selling costs per unit, and in the cost of distribution; second, there is a larger opportunity to utilize by-products, which in small-scale production would be of too small a quantity to be economically treated; third, the financial resources of the big business are such that it can maintain the very expensive research or experimental laboratories that a small organization could not afford, and that lead to important improvements in the industrial process; fourth, in large-scale production the quality of the management may be improved, as size makes possible systematization and specialization; fifth, methods of production can be standardized and specialized, the principles of mass production or "scientific management," with their saving in labor time, may be more thoroughly applied; sixth, this mass production and specialization makes it possible to increase the use of machinery relative to labor cost; this reduces the seriousness of the labor problem. Moreover,

larger units of equipment may be devised and made use of, the result being a relatively decreased investment in machinery because of the proportionately greater performance of each machine unit and the smaller amount of space used up.

Concerning large-scale management in particular, it is felt that there is a saving on expenses of administration through the concentration of management in a central office, and in the greater efficiency to be derived through specialization in the unified managerial force; that is through the general use of experts.

20. The Committee on Trusts of the British Ministry of Reconstruction, in 1919, pointed out that in America and Germany consolidation and large-scale production had grown up to a much greater degree than in England. It argued that the process should be encouraged in England, if the costs of production in England were to be lowered and English industrials therefore better able to compete with the manufacturers of post-war America and Germany. The committee's findings as to the economies of large-scale production are as follows:

> Great possibilities of industrial and commercial improvement lie beyond the confines of free competition, and are only to be realized by combination in one or other of its several forms; by informal consultation and cooperation, by formal association or by actual amalgamation. These may be tabulated as follows:
>
> Buying (materials, plant, stores, etc.)
>
> - Assured and steady supply of material.
> - Unification of buying partners and staffs.
> - Bulk instead of detail purchases.
> - Greater opportunity for comparison and selection.
> - Cheaper credit and better discounts.
> - Standardization of materials.

> Making.
>
> - Standardization of product.
> - Specialization in product.
> - Improvements in plant.
> - Use of by-products.
> - Equalized distribution of work.
> - Quality.

> Selling.
>
> - Transport economies.
> - Unification of selling departments and staffs.

Extension of export trade.
Collective advertising.
Lower costs of distribution, fewer middlemen.
Knowledge.
Interchange of data and experience.
Standardization and interchange of costs.
Collection and dissemination of trade statistics.
Promotion of scientific and technical research.

The above are possibilities of combination, not the necessary accompaniments or the invariable achievements. It should be stated at once that no association among the many hundreds existing in the United Kingdom at the present time, and few of the numerous mammoth amalgamations, have come as yet anywhere near realizing them in full.

As a matter of fact, however, although these economies have actually been attained in many consolidations, the result being large-scale production, in many other cases they have not been attained. In a study of the results of thirty-five industrial consolidations effected since 1900, it was discovered that the earnings of the separate businesses before consolidatoin were 20 per cent. greater than during the first year of the consolidation. Moreover, the earnings of the first year were, on the average, about 40 per cent. less than the promoters of the consolidations estimated they would be. Furthermore, afer this first bad year, things did not improve. In fact, the earnings of the first year were, on the average, 10 per cent. larger than the average earnings during the first 10 years following the consolidation. And the earnings of the tenth year were distinctly less than those of the first year; this even after the consolidations had had 10 years in which to enlarge and rehabilitate their plants, and technically to adjust them to one another's operations. In the light of the anticipated economies of production and distribution, etc., a large percentage of industrial consolidations have proved a failure.

21. Different factors have been at work in various individual instances. In many instances the new management has proved unequal to the larger tasks imposed by consolidation. The loss of the more direct human touch of the independent managements of the original and smaller organizations

has resulted in inferior product, waste of material, and loss of good-will on the part of the workers.

The second significant factor in the failure is that mere size often proves a handicap in competition with the smaller competitors. Especially is this true in making the large company less able to stand depressions in trade than are the more mobile smaller companies. And, instead of getting raw materials at a lower cost, the large company finds it more hazardous to contract for the large quantities required for sustained production; partly because the very publicity of the company's demands tends to raise the prices it is forced to pay. This is especially true for large consolidations that use a staple raw product, such as cotton, wool, corn, or pig iron. Large orders have to be placed openly, often with one or two or three large producers, who alone are able to guarantee deliveries. A small competitor on the other hand, can "go shopping" in the market, purchasing, secretly, odd lots at a marked concession from the established prices. In many instances, therefore, quantity purchases prove a disadvantage rather than an advantage. During the early years of the starch and glucose consolidation, a small competitor demonstrated his advantage over the consolidation. In periods of small demand, when heavy overhead charges made operation impossible, he would close down his factory. When the demand grew again, he would again begin operation, and purchase odd lots of ungraded corn. Thus he was able to produce glucose cheaper and undersell the consolidation. Small as was his possible production, he was yet able to make it impossible for the consolidation to maintain its prices uniformly in all markets.

It might be observed further that, in the financing of many consolidations, the basis of earnings has frequently been *expected* earnings; and, as has been seen, these expected earnings, on the average, have been 40 per cent. greater than the earnings actually turned out to be. The result was that the urgent demand of the excessive issues of stock, for the earliest possible declaration of dividends, had a bad effect on many of the managements. Many of the consolidations were, for years after the consolidation, reluctant to reinvest earnings for

the purpose of substituting improved machinery and equipment for that acquired with the consolidated plants as that equipment became obsolete. As a result, competitors would enter the field, having no old machinery to begin with and no obsolescence charges to face, and beginning operations with the latest and most efficient equipment, would produce more cheaply and undersell the larger and older competitors.

22. One should not, however, conclude that consolidations aiming at large-scale production necessarily, or always, fail to achieve the ends aimed at. Some do achieve these ends. It seems that some lines of business are adaptable to large-scale production while some are not. A recent writer summarizes some conditions that distinctly favor large-scale production:

1. When the sources of supply of the raw material most needed are limited and are largerly controlled through integration. A unique example of this sort is furnished by the United States Steel Corporation, which through its vast organization is able to produce steel at a lower cost per ton than most of the independent competitors.
2. When the product is capable of rather minute standardization, combination may sometimes be effectively carried out. In such cases the aim is "mass production," usually at a low price without any attempt to cater to individual taste or to develop specialties.
3. It is true beyond a doubt that combinations or large-scale single enterprises are most likely to succeed when comparatively large amounts are used in production along with labor. When the operations of labor can be reduced to narrow routine so that machinery can largely take the place of man power, or when relatively few workers are employed in proportion to the amount of capital invested in the plant, the human factor is minimized to such an extent that standardization and mechanical perfection may result in financial gains.*

Moreover, in many lines of production, economical production cannot be achieved except by having an independent management that is peculiarly interested in and acquainted with, the particular requirements in the plant operated. Experts located in some far-away office cannot possibly adequately see to the proper management of the local plant. Furthermore,

* Lincoln in *Applied Business Finance*.—A. W. Shaw Co., Chicago. $4.

in such lines, there has proved to be a limit to the expansion of the plant that the independent owner can efficiently manage. For instance, the finer and more specialized the goods produced, the smaller ordinarily will be the most profitable size for the establishment of the business. Large-scale American woolen mills, with large-scale production consolidated managements, can most cheaply produce low-grade or medium-grade cloths. But they have never been able to compete in the field of production of high-grade fine woolens, which must be made in mills where hand labor counts for more in production than machine labor, and where a painstaking personally interested manager is on hand in person all the time to supervise all the details of production.

A study by Lincoln, for example, of 291 garment-manufacturing companies is illuminating. The results indicate that the largest net income is realized by those small concerns whose invested capital averages only $7,000. These no doubt confine themselves to hand work and the manufacture of specialties. They have few fixed obligations arising from the purchase of machinery and other equipment. Larger concerns whose invested capital averages $40,000, show much smaller net earnings in relation to investment. For concerns with an average investment of $1,175,000, the rate of return is higher than that of any group below the $7,000 class, but is 30 per cent. less than that of this smaller class. The intermediate groups are apparently those which are growing up from the state of small handicraft concerns, which are putting in more and more money in machinery, and, consequently, show decreased net earnings. The concerns with average net earnings of $2,350,000 show a net return of nearly 50 per cent. less than that of concerns with an average investment of $1,175,000, the next group below them in point of size. It would seem, therefore, that in the clothing industry all the economies of large-sized production are attained in the $1,175,000 class, and investments beyond that stage carry one into a region of decreasing returns.

Likewise, similar investigation among concerns that make steel castings exhibits the fact that the highest net returns is reported from concerns with an average investment of only

$9,200. Beyond this group net earnings are, proportionate to the capital investment, less, and the percentage of return decreases with the size of the investment until we reach concerns with from $2,000,000 to $5,000,000 invested, beyond which stage there is again a decrease in proportionate net returns.

Similar results were shown by investigation of forging and foundry companies and of machine tool companies; on the other hand, investigation into electric light and power stations indicated a progressive advantage in increasing size, but, nevertheless, only up to a given point.

23. In the retail merchandising business, somewhat variant considerations come into play. The modern development of chain stores is particularly interesting. Just how big can a chain-store organization grow before it begins to show constant decreasing returns on the investment? This question cannot as yet be answered definitely with respect to any one type, or all types, of chain-store organizations.

The chain-store plan consists of applying the principles of mass production—here, quantity purchasing, standardized operation, and rapid selling—to the retail business. The only attraction they can offer the buying public is quick service and cheaper goods. There will always be a field they cannot control so long as there are people who prefer quality, the satisfaction of individual taste, style in packing and delivery, and so on, more or less regardless of price. But most of the potential customers after whom the chain store reaches are those many millions of the masses who care first of all about price. There is room, therefore, yet, for tremendous and indefinitely extended growth. Moreover, the problem of management which they face is relatively simple. Every store is like every other store in the chain, practically speaking; and even store management can be safely standardized. No problems arise, in the management of a consolidation of twenty stores of the same general character, that did not exist in the management of five or ten. Furthermore, the chain stores have a source of financial strength in the fact that they are distributors of necessities, and that

they are the lowest-price distributors of these necessities. While industrials suffer in depressions—the larger concerns much worse than the smaller ones—the chain store not only does not suffer, but prospers. People must have the necessities of daily living; moreover, in times of depression, people who ordinarily patronize other types of stores rush to the chain stores and profit by their lower prices.

It is probable that there is no limit as yet on the horizon to chain-store expansion so long as the expansion is along lines that keep the problem of management simple and therefore maintains high efficiency. But let a chain-store organization do as some are beginning to do, attempt extensive consolidation with the sources of supply—that is, to form vertical consolidations—or attempt the consolidation of stores merchandising very different lines, or, finally, enter the field of merchandising other than generally used low-priced articles, and the problems of management of the chain stores would become so complex that they would be less profitable, and there will be very sharp limits set to their capacity for expansion.

FAILURES AND REORGANIZATION

BUSINESS FAILURES AND RECEIVERSHIPS

24. Insolvency.—No matter how well a business is financed and managed, the time may come when it will encounter difficulties. Such difficulties are not necessarily due to incompetency or inefficiency of management, but are frequently due to causes over which the managers of the business have no control. So long as the enterprise is able to meet all its obligations, and make a fair profit, it is said to be successful or prosperous. On the other hand, when it is no longer able to meet its obligations it finds itself in trouble. Sometimes its difficulties may be such that the managers will be able to extricate themselves without actually failing in business; then, again, it may become necessary for them to admit

that they are no longer able to meet the demands of their creditors.

A company is financially embarrassed when it is unable to meet its obligations in the usual course of business. This embarrassment may be temporary, depending on the nature of the causes and the possibility of eliminating the trouble. If the situation continues to grow worse it may lead to insolvency. *Insolvency* is that condition in which a business finds that its liabilities exceed assets; or that it cannot meet all its debts as they mature in the ordinary course of business. There is an excess of immediately maturing liabilities over the means with which to pay them. The result is default in the payment of interest on bonds, or other failure to meet its obligations to creditors.

A business may be insolvent, without being totally insolvent; that is, without its assets being less than would at a fair valuation be sufficient to pay off its debt liabilities. For, although its assets may be far in excess of all outstanding obligations, it is quite possible that a business may not have at a given time sufficient money to meet current payment for wages, interest, and the like. Also, it may be wholly unable immediately to convert assets into cash in order to pay its open accounts or bank loans that have fallen due. Perhaps it is a case in which extensions that, once they are completed and employed, will yield substantial increase in the earnings of the company; yet these have been financed by an issue of short-term notes, which fall due at a time of unforeseen financial stringency and cannot be funded or renewed.

25. There are many causes of business failures. They may be divided into two main classes: first, causes due to conditions inside of the enterprise; and, second, causes due to outside conditions.

One of the chief causes for business failures is the lack of foresight on the part of the management of the affairs of the concern. We have already indicated the danger of too great optimism in periods of prosperity; the failure to observe the general trend of business conditions, and to realize that,

sooner or later, a period of prosperity will be followed by a period of dullness in business.

A second cause for failure is incompetency or inefficiency in management. Many businesses today are so poorly organized, and so badly managed, that it is surprising that they are able to continue at all. Some of these concerns succeed in spite of poor management, but are constantly in difficulties. Poor organizing, buying, operating, and selling may cause trouble, and therefore the importance of efficient management of the three main branches of a business cannot be too much emphasized.

A third cause for failure in business is carelessness or indifference. This may be displayed not merely by the employes but often also by the management. Much of our so-called safety legislation in industry is intended to remove the causes for loss of property and for possible business failures due to carelessness.

A fourth reason for failure may arise from the use of antiquated methods of production when modern up-to-date methods can be employed. Many business men have become so set in their ways that they refuse to listen to new ideas; they stick to time-worn methods of production and sale, and sooner or later bewail the fact that they are not able to make both ends meet because of the encroachment of other businesses on their territory.

A fifth and very important cause for business failure is the inadequate provision for working capital in the financial plan of the business. Where the management fails to take note of this fact it will eventually find itself in difficulties. Again, a corporation may adopt an unwise dividend policy, paying out too much of its net earnings in the form of cash dividends, and thereby impairing its working capital. Often corporations find themselves in trouble and fail, because they have burdened themselves with too heavy fixed charges. As soon as a slight business depression sets in, they find that they will not be able to meet their fixed obligations and the result is failure. Lastly, one of the outstanding reasons for business failures due to causes within the business is a poor sales and

collection policy. If collections of bills are slow, outstanding accounts will tend to accumulate also. A business may find itself unable to meet these bills, not because it had not sold its goods but simply because it has been too liberal in the extension of credit to its customers.

26. Practically all of the foregoing causes for business failures can be grouped together under the head of incompetency. Only careful training and long experience in business financing and management can remove these causes. Even if it were possible to remove all the causes for failures due to lack of ability or training on the part of the management, there are certain causes for business failures over which the individual concerns have no control. They are referred to as outside causes.

In the first place, most businesses, unless they have a monopoly of the market, are competing with other corporations producing similar products. When the competition or rivalry in buying and in selling becomes too keen, those concerns which feel the pressure of competition most can do one of two things; they can either sell out and discontinue their business or combine with their competitors. Too often companies will continue operating until they are forced by circumstances to admit their failure.

A second outside cause for business failure arises from changes in the demand for products. Such changes in demand may be due to changes in tastes of individual people or changes in their purchasing power; again, it may be due to legislation. When, for example, a manufacturer has anticipated that his product is going to be demanded, and he proceeds to manufacture in the hope that he will be able to find buyers for his goods, he may discover that the tastes of the people have changed, and he is, therefore, unable to sell his product at a profitable price. Human beings like a change now and then, and the business man is always confronted with the possibility of such a change. When, for example, the automobile developed, carriage manufacturers found that the tastes of the people for carriages were a thing of the past, and many a

city blacksmith converted his business into a garage because of the change in the demand for his product. The coming of the radio has apparently very definitely affected the talking-machine business and some of the large manufacturers of such machines are today in financial difficulties. The World War resulted in a great loss of property, and many industries, producing articles that were not essential during the war and for which the individuals did not want to spend their money, found that their business suffered. This was particularly true in some of the European countries. The passing of the 18th Amendment resulted in a large number of business failures because the industries which were engaged in the manufacture or sale of liquor were compelled to go out of business.

The business cycle is a cause of business failures. In a period of rapidly falling prices, many wholesale concerns find that their debtors are unable to meet their obligations, and that their stock of unfinished goods cannot be sold except at a heavy loss. As a result the wholesalers are not able to pay their own bills when due and, in consequence, they fail. In 1922, there were no less than 23,676 business failures in the United States—the largest number of business failures in any one year since 1867—the earliest date of record. On the other hand, the number of failures of businesses having a capitalization of $100,000 or more is relatively small, representing in 1922, only 3.7 per cent. of the total. This tends to show that it is the small business that has the hardest task to succeed in the present industrial world. Much of the trouble of the small concerns arises from the fact that the promoters, as well as the managers, are incompetent, because of the lack of proper training in business finance and organization. Finally, there are some causes of failure over which the individual has not control, and which are referred to as casualties due to the "Acts of God." The only protection against such casualties is insurance; that is, providing a fund out of which to replace losses due to such casualties.

27. The extent of business failures in the United States in recent years is reflected in the following figures taken from

the Federal Reserve Bulletin for February, 1925. Commercial failures were more numerous in every month of 1924, except January and November, than in the same months of the year before. There was a total of 20,615 failures last year, which was 10 per cent. higher than the total for 1923. On the other hand, the amount of liabilities involved in each of these failures was on an average considerably lower in 1924 than in the preceding year. But both total failures and liabilities involved were considerably above the level of most years prior to 1920. In fact, insolvencies were more numerous during 1924 than in

TABLE I

COMMERCIAL FAILURES, 1915–1924

Year	Number of Failures	Percentage of Total Number of Commercial Concerns	Total Liabilities Thousands of Dollars	Average Liability of Each Failure	Large Failures Per Cent. of Total Number	Per Cent. of Liabilities of Large Failures to Total Liabilities in Default (Failures Involving $100,000 or More Are Classified as Large)
1915	22,156	1.32	302,286	13,644	1.5	40.6
1916	16,993	.99	196,212	11,547	1.3	33.9
1917	13,855	.80	182,441	13,168	1.8	44.9
1918	9,982	.58	163,020	16,331	2.3	50.3
1919	6,451	.38	113,291	17,561	3.0	49.4
1920	8,881	.49	295,122	33,230	5.1	65.0
1921	19,652	1.02	627,402	31,926	4.4	59.8
1922	23,676	1.19	623,896	26,351	3.7	51.9
1923	18,718	.94	539,387	28,816	4.0	59.5
1924	20,615	1.01	543,225	26,351	3.2	55.3

any other year except 1915 and 1922. The total for 1922 was 23,676, which was the highest number of failures recorded for any one year, whereas in 1919 there were but 6,451, the lowest number of failures recorded. The 1924 aggregate of debts in default has been exceeded only in 1921, when the record of $627,402,000 was reached, and in 1922, total liabilities in default have averaged nearly $600,000,000 annually during the years 1921–1924, whereas in the 25 years prior to 1921 there

were only three years with annual totals much over $200,000,000.

Annual data relative to commercial failures in the United States is contained in Table I.

These striking figures indicate clearly that in the business world of today there is a real struggle for existence. Only those who are well trained and who have developed efficiency and ability can "carry on" effectively.

28. The companies which fall into difficulties can be divided into two classes; those which are not worth saving, and those which are worth saving. The former will be allowed to perish; they will pass out of the field of industrial activity by the sale of their assets. On the other hand, there are concerns which fail owing to causes that can be removed, and when once removed, such enterprises can again be made prosperous.

The method of procedure in saving the companies that are worth saving is closely akin to the methods employed in curing a disease. We may temporarily alleviate the symptoms while not removing the causes of the disease. On the other hand, we may cure a person by not treating symptoms but by actually removing the cause. So also in the case of concerns that have failed. Once the cause for failure is removed, there is no longer the danger of subsequent failure. The first requisite, therefore, in reestablishing a business that has failed is to try to remove the causes for failure. If it is found that the cause is poor management, it is necessary to provide a new and more efficient management. If the cause is inadequate capital, additional capital, either in the form of fixed capital or of working capital, must be furnished. If the cause is an unsound financial plan, with the heavy fixed charges because of an overissue of bonds, it is necessary to reduce the fixed charges. The procedure in removing the causes for business failure and reestablishing the business on a working basis as a going concern is called reorganization.

If a business is not totally insolvent, serious difficulties may be averted by the forbearance of creditors or by insignificant

adjustment of claims; if the business is not seriously deteriorated, slight readjustment of the capital account; if the business is in a serious condition, a thoroughgoing reorganization, or liquidation, may be necessary.

29. Security Holder Committees.—When a business corporation is unable to meet its debts, the owners of the bonds and other obligations may agree voluntarily to a readjustment, or settlement of their claims. Committees of the security holders are formed, and agreements reached without receivership proceedings. A readjustment of claims, practically a reorganization of the company, may be effected voluntarily. This is true for all corporations, especially when the decline in the corporation's credit has been gradual, obvious, and due to fundamental defects in organization. Sometimes committees close to the management are formed before failure has reached a critical stage. A receivership may be applied for after the committees have tried in vain to reach an agreement. If there is acrimonious and prolonged dispute among the various security holders; or if a recalcitrant group tries to impede or frustrate an amicable settlement; if the failure is very serious, entailing large losses to all concerned, or if it involves a large railway embodying many conflicting interests, or if there are burdensome contracts that must be abrogated at all hazards, receivership proceedings will be inevitable.

However, receivership proceedings are today often dispensed with by the formation of protective committees. This is the one step almost invariably taken by the security holders of every corporation failing, or likely to fail, to meet its obligations.

The committees arise from two different sources; the stockholders and the creditors. Invariably there is at least one stockholder's committee, usually dominated by the old directors of the corporation. This committee acts on the defensive. Throughout the whole course of the readjustment or of formal reorganization proceedings the stockholders' committee is engaged in explaining and justifying the past management, and in haggling with the other committees as to the sacrifices which the stockholders may be forced to make to regain control.

The other types of committees are representative of the different classes of creditors. In intricate industrial reorganizations there may be separate committees representing the merchandise creditors, the bank creditors, and the public holders of the notes and debentures. In intricate railway reorganizations there may be committees of junior bondholders, senior bondholders, or branch and divisional line bondholders, and of the bondholders of subsidiary lines or terminal properties controlled through leases or operating contracts. The committees of the holders of the floating debt are usually formed and dominated by the large bank creditors. The committees of bondholders are formed and dominated by the investment banking houses that were responsible for the original sale of the bonds to the public; if the bonds have been outstanding a long time prominent trust companies or life insurance companies may take charge.

The formation of committees is wholly a matter of invitation and mutual agreement. The method usually employed in their formation is for individual bondholders to constitute themselves or their representatives a committee to take charge of the interest of their particular class of securities, and to invite the creditors or stockholders to signify their consent to this arrangement by depositing their securities with some disinterested agent, a trust company or a bank. If a majority of the securities of that class are deposited the self-constituted committee becomes representative and is recognized as such by the courts. The powers of the committees are very broad. The committee is vested with the legal title to all securities deposited with them. There is conferred upon the committee all the rights and powers of owners of these securities, under the terms of the deposit agreement, and full discretion as to the methods of carrying out the agreement, with power to construe it. The committee is usually authorized to maintain necessary suits; to sell the deposited securities under certain restrictions appropriate to the case; to put in motion suits to foreclose mortgages; to purchase the property at any sale, using the deposited securities, so far as may be, in payment of the purchase price; and to convey the property to a new

company or otherwise to dispose of it. It may employ attorneys and counsel, borrow money on the security of the deposited stocks or bonds, and so on. The effect of the deposit of securities is to constitute the members of the committees as trustees for the depositors, to form, as it were, a temporary corporation for the attainment of certain objects.

It is the custom to have well-known, highly responsible men serve on the various committees; men chosen more for their reputation in banking circles, their acknowledged integrity, proved wisdom, and financial experience, than because they own or control a considerable block of securities. Large and important corporate reorganizations require highly expert and specialized knowledge.

30. Receiverships.—If these committees cannot agree to a voluntary readjustment and thus save the cost of a receivership, a receiver is appointed to administer the business until an agreement is finally reached as to the reorganization plan. If a receivership be resorted to, a thoroughgoing but fair reorganization may be effected because then the court may, in the end, by a judicial sale of the bankrupt corporation's property, force recalcitrant minorities to accept what it considers a just reorganization plan, or extinguish their interests. A reorganization effected without compulsory pressure by the courts through the means of a judicial sale of the property is called a voluntary reorganization, even if a receiver has been appointed. One effected only by the compulsion of a court through sale of the property of the old corporation to a new corporation organized to take it over, is called an involuntary reorganization.

The object of a receivership is the preservation intact of the property pending reorganization. It is the receiver's function to administer the affairs of the insolvent concern in such a manner that the assets will be conserved for the benefit of the creditors, so that the property may be turned back to the owners in an undeteriorated condition, or if need be, that it may be preserved until it may be equitably distributed to the various creditor interests.

A court of equity appoints a receiver for the property, upon due request from secured and unsecured creditors, or upon the request of the company itself or of its stockholders. Directors of a corporation may see, long before any creditor, the impending insolvency of the company. At the first sign of disaster they may fly to the shelter of a court of equity, even before any creation of committees, and attempt a voluntary readjustment. The directors of the corporation will approach a judge either in his courtroom or privately. Accompanying the directors will be a creditor of the company. The attorney of the company informs the judge to whom he will in most cases be well and favorably known, that his client, the corporation, is insolvent. As evidence of the fact he introduces the creditor. The creditor states that the company owes him certain money. The officials of the company present confirm his statement that the debt is due, and that the company is unable to pay. The court is asked to appoint a receiver to take charge of the property in the interest of all concerned, until the corporation's affairs can be adjusted; the argument being made that alternatively the various creditors of the corporation will seize upon the property and make it impossible for the property to be used in rendering its usual functions. It may be pointed out that the company is merely temporarily embarrassed, financially, and that it is otherwise economically sound; that the situation is due to special, exceptional causes; that a few months' protection from creditors will enable it to extricate itself from its difficulties. The procedure is termed making out a *prima facie* case for the appointment of a receiver. Such procedure, conceivably, may be followed with attempt to defraud. If the court is satisfied that there is no such motive in the request, it appoints a receiver. The appointment is at first temporary, pending a hearing of all other parties in interest. Then, if no good reason appears for discharging the receiver, the receivership is made permanent.

Usually there will have been at least three conflicting interests that the court will have to take into consideration; the secured creditors, the unsecured creditors, and the stockholders. The stockholders have an interest which they will be deprived of

if the property is taken from the control of the corporate officers, and they are heard along with the creditors, despite the fact that they themselves are not creditors of the company. The stockholders particularly have an interest that deserves recognition and protection by the court in case of embarrassment of the company due merely to temporary and superficial causes; the company's embarrassment, for example, may be due merely to the maturing of an issue of short-term notes, which momentarily cannot be funded because of an unfavorable bond market.

The receiver appointed is often an official of the insolvent corporation. He may be the corporation's chief counsel. The judge is not familiar with the business of the corporation and feels it incumbent upon himself to appoint as his agent someone conversant with the business, who will be able to continue it as a going concern as successfully as possible. The business and property might suffer if a stranger were appointed to take charge.

When large public companies apply for a receivership the court is careful to appoint a receiver who will be satisfactory to all parties concerned. If the receiver is shown incapable or untrustworthy for any reason, or if, with a particular person in charge as a receiver, banking interests refuse to come to the financial assistance of the company, the court will remove the receiver and appoint a more acceptable person in his place.

31. The receiver, whoever he may be, is officially an officer of the court, holding property and attending to the management of it for the court. While the receiver holds the property, no person can attach or levy on the assets without the consent of the court. Thus a receivership usually places the property beyond the reach of the creditors and effectually prevents the dissipation of the property through haphazard seizures of parts of it. It will not prevent bankruptcy proceedings, however, in proper cases.

Immediately upon his appointment, the court usually gives the receiver very extensive powers. During a receivership, payments to creditors will be postponed, and funds may be

obtained to enable the business to carry on. The receiver may employ such counsel or agents as he may deem necessary. He must ascertain as accurately as possible the status of the corporation and make full report to the court for the court's guidance. For all extraordinary actions, such as the discontinuance of interest on bonds or the sale of certain property, he must obtain express authority from the court.

When a receiver takes charge he usually finds that the property has been allowed to deteriorate, because inadequate funds have been available for maintenance during the period of approaching failure. He may find a large amount of wages and audited vouchers due and unpaid. There are rentals due on leased property that is essential to the maintenance of the business. Under authority from the court the receiver may suspend payment of interest on bonds, but owners of leased property need not submit to forefeiture of rentals; the court has no title to rented property. Usually the need of the receiver for cash is so great that the earnings of the business, even with some suspension of bond interest, are inadequate. He may then issue receiver's certificates upon leave of court.

These are in effect short-term notes. They are negotiable, and the holders have such priority claims as are indicated in the order authorizing the issue. The court, having general equity powers, may order the priority in any way it deems necessary to protect all interests. These certificates may be either without due date, or they may run for a definite period. An illustration of the first type is the following, issued in 1880 by the receivers of the Philadelphia & Reading Railroad Company:

RECEIVERS' OFFICE, PHILADELPHIA & READING RAILROAD COMPANY.

Philadelphia, May 24, 1880.

This is to certify that there is due to ..... or order from Edwin M. Lewis, Franklin B. Gowen, and Stephen A. Caldwell, receivers of the Philadelphia & Reading Railroad Company (and not individually) one thousand dollars, on account of money borrowed by said receivers, under order of court, for payment of wages and interest upon certain mortgage indebtedness of said company.

This certificate is transferable by indorsement, and redeemable after ten days' notice by advertisement in one or more daily papers

of the City of Philadelphia, of the readiness of the receivers to make payment at the expiration of which notice interest thereon shall cease.

Receivers,

(Signed) W. McKENNA, Circuit Judge

The later form of certificate is illustrated by those issued in 1910 by the receivers of the Illinois Tunnel Company:

This is to certify that for value received Charles G. Dawes and David R. Forgan, as receivers of the Illinois Tunnel Company, and not individually, are indebted to the bearer hereof in the sum of one thousand dollars ($1,000), payable at the National City Bank of New York, in the City of New York, or, at the option of the holder hereof, at the Continental National Bank, in the City of Chicago, two years from the date hereof, in gold coin of the United States of America of the present standard of weight and fineness, with interest thereon at the rate of (6%) six per cent. per annum, payable semiannually, in like gold coin, on the first days of October and April, upon presentation and surrender, at one of the places therein specified, of the coupons for said interest as they severally mature.

This certificate is part of an issue of certificates of like tenor and date not exceeding in the aggregate the principal sum of three million, five hundred thousand dollars ($3,500,000) at any one time outstanding, authorized by an order of the Circuit Court of the United States for the Northern District of Illinois, Eastern Division, dated the 16th day of March, 1910, and on said day filed in the office of the clerk of said court, entitled in two certain actions pending in said court and consolidated under the title of The Corporation Trust Company against Illinois Tunnel Company and Central Trust Company of Illinois, as Trustees, against the Illinois Tunnel Company, and others. This certificate is issued pursuant to and is entitled to the benefits and security specified in the foregoing order, subject to all the terms and provisions whereof this certificate is issued and held. Among other things it is provided in said order that:

Said certificates of indebtedness to the amount of the principal and interest thereof shall constitute a lien upon all the property of every nature and description of the defendant Illinois Tunnel Company, and upon the telephone system which may be construed by the said receivers, and upon all equipment and other property that may be acquired or provided by means of the said certificates or the proceeds thereof, and upon all the net earnings and income which may hereafter result from the operation of the property in charge of said receivers, which lien shall be prior to the lien of the judgment received in this Court by the Corporation Trust Company

against the Illinois Tunnel Company on December 1, 1909, for $1,129,428.64, and prior to the lien of the First Mortgage or Deed of Trust, dated December 1, 1903, made by the Illinois Tunnel Company to the Equitable Trust Company, Chicago, as Trustee (under which indenture the Central Trust Company of Illinois is now the duly constituted and acting successor Trustee), and prior to the rights of the holders of any and all bonds issued under the said First Mortgage or Deed of Trust.

These obligations are managed like short-term notes. They may be issued to consolidate other issues of the same kind; they may be called at any time, or they may be extended at maturity.

32. Receivers' certificates are issues to obtain money for a variety of pressing needs; they will usually be issued in small amounts to obtain money wherewith to pay pressing claims such as for wages and supplies. Later, larger issues may provide for repairs that are necessary to the operation of the property. Bondholders will have no objection to the provision of money through the issuance of receivers' certificates, despite the fact that the lien of the certificates may, as the court determines, precede the lien of some or all of the mortgage bonds; for if the receiver did not so provide money for these purposes the property could not be economically operated and its value would drop, to the prejudice of these bondholders' interests. As an example: The receiver of the Third Avenue Railroad, New York City, appointed January 12, 1908, 4 months later reported to the chairman of the Bondholders' Committee. He described the situation resulting from previous neglect of the property and pointed out what he felt to be necessary to do to restore it to efficient and economical operation. This part of his report reads:

Physical Condition.—The general conditions of the Third Avenue Railroad were very bad; there were no offices, no supplies, no materials on hand, the shops had been neglected; the track was and is in very bad shape; the cars in need of extensive repairs. The power house alone was in good condition.

The supplies and materials immediately necessary, most of which has been received, amounted to $50,000. Sprinkling apparatus in all of the barns and the cost of the various other fire apparatus essential

to secure new insurance, the old policies, after the repeated fires in the New York City Railway barns, having been nearly canceled, amounted to $135,000; I hope presently that the property upon the system will meet the requirements of the most exigent underwriters.

Car Repairs.—Of the 567 cars delivered to me by the New York City Railway Company receivers, there was not one on which some work was not immediately necessary. I ordered a sufficient number of new motors and controllers (50) to fully equip every car in the system. I estimate the total cost of putting all the cars in order, including the new motors and other electrical equipment, to be approximately $300,000.

Repair to Track.—In many places on the main line of the Third Avenue track the contact rail is completely worn away, the slot rail very thin, and the car rail worn to the breaking point. Paving of the tracks, in accordance with the city ordinance, with Belgian blocks, will save $5,000 or $6,000 a year in maintenance. Under a temporary arrangement with the New York City Railway receivers, we are to repair the crossings on joint account. Altogether there will be needed for the track this year about $436,000 and thereafter, with a liberal allowance for maintenance, I think no further expenditure will be necessary for some years to come.

Buildings.—The building at Sixty-fifth Street and Third Avenue needs extensive repairs to the roof, and in order to enable the shops to do their work certain other structural alterations are required, bringing up the total cost to about $151,000 for $14,821 of which amount I have let contracts.

At 129th Street and Third Avenue there is, in front of the car barn, a building used as a hotel and several tumbledown stores or saloons. I propose to clean out the main building and construct therein proper offices for the Third Avenue and other lines; also accommodations for a club for the employes, which are much needed. The whole improvement will cost nearly $106,000.

To meet the cost of these and other improvements and payments the receiver stated:

I intend to ask the court for authority to issue $2,500,000 of receivers' certificates, payable within one year and bearing interest at the rate of six per cent. With those and the earnings from the property I think I can do all of the work and make all the payments which I have here enumerated. It may be desirable to issue a certain number of certificates of the Union Railway, to an amount necessary to pay for the car barns, the Bronx & Pelham Parkway construction, and for the power station, not exceeding in all, however, $750,000, which could later be taken up by the Third Avenue certificates; or it may be desirable, while having authority, to issue

certificates for the Union Railway, as above mentioned, as I already have authority to issue certificates for the Forty-second Street and Dry Dock Railways of which I have not availed myself, to issue Third Avenue certificates for the whole amount of $2,500,000 directly, as the bankers may prefer those to certificates of the other roads. If the certificates of those subordinate lines could be used permanently, the Third Avenue certificates could be diminished *pro tanto*, but in any case only certificates for $2,500,000 for one year will be outstanding.

33. The function of the receiver is to preserve and protect the property, and the business in which the property is used. He aims to maintain the earning power of the business, which earning power very largely determines the value of the property. To carry out the function of preservation, however, in business, as in all departments of life, more may be required than the playing of a mere passive role. There are times when expansion must be undertaken or completed, when crises develop in the course of competition which, if not met, may endanger the very life of the business. So the receiver in preserving the business and property may be called on to pursue expansion aggressively. To acquire the necessary funds he may go to the extent of issuing enormous amounts of receivers' certificates—with, of course, the authority of the court.

The property of the company may, as in the case of the Illinois Tunnel Company, whose receivers' certificates were exemplified above, be only in part completed. It is necessary to complete it immediately if profitable business is to be secured. It may be that, originally, in anticipation of such new construction, contracts with consumers may have been signed, the binding force of which depends upon the delivery of goods or services before a certain date. The company may have failed while the new plant is unfinished, and the receiver is appointed. A rival concern may appear, ready to seize the business, which will go to the corporation in receivership if it can finish its new construction in time. Under such conditions the receiver may go even to the extent of mortgaging the property to obtain funds for its completion. The existing creditors of the company may object to the court against the

receiver's plans, but the court will sanction them if it feels the measures to be taken are to the best interest of all concerned.

A standard illustration of this aggressiveness of a receiver is afforded in the example of the Baltimore & Ohio Railroad many years ago:

In 1896 Mr. John K. Cowen and Mr. Oscar G. Murray were appointed receivers. They found the property of the Baltimore & Ohio to be hopelessly deteriorated and in need of entire reconstruction. Every part of the property was in need of repair or replacement, from roadbed to locomotives. The equipment, however, was especially run down. Much rolling stock was completely out of service. The equipment available for use was inadequate to meet the needs of the shipping and traveling public and to produce revenues for the company. At the same time competitors were threatening; the Pennsylvania and the Chesapeake & Ohio were gaining on the prostrate Baltimore & Ohio through its inability to take the aggressive or to furnish service efficiently and at low cost. New capital would have to be acquired for the B. & O. eventually. Delay would merely mean a failure to take advantage of opportunities that might be lost forever. So despite powerful opposition, the receivers determined to rehabilitate the property immediately. Within 2 years they had issued more than $2,000,000 of receivers' certificates, and a large amount of car-trust certificates. Some of the receivers' certificates were for the purpose of retiring other indebtedness, but most were for the purchase of rails and ties, while the car-trust certificates were the means of the acquisition of new rolling stock. In the first year of the receivership five thousand new freight cars and seventy-five new locomotives were acquired; and in the second year, over six thousand more freight cars; and during this second year more than two thousand cars were obtained from coal companies on mileage contracts and three thousand cars were leased from the Pullman Company.

By way of repairs, during the first year two hundred and twenty-five hopelessly run-down freight locomotives, many of

which had long been out of service, were repaired and put into service. Bridges were replaced; heavier rails were laid. Yards and sidings were improved. The largest order ever placed up to that date for rails was given, with a view to taking advantage of low prices due to depressed business conditions. As a result of all the reinvestment of earnings and of new capital although the gross earnings of its competitors decreased, the gross earnings of the B. & O. increased materially during the receiver's term of office. In 1896 the B. & O.'s gross earnings were $25,500,000 approximately; in 1898, despite a steady fall in rates, they increased more than $2,000,000. Increased efficiency had brought a drop in operating expenses; the operating ratio was 69.26 per cent. in 1895, reflecting the inefficiency of the property; in 1898 it was 78.23 per cent. By 1899 this per cent. had dropped to 76.70; in the next year to 65.63. The receivers had justified their insistence that they had taken steps which were for the best interests of the debtors of the insolvent company.

REORGANIZATION

34. Plans and Operations.—Reorganization is the remolding of the financial plan of an embarrassed or insolvent corporation. This may be accomplished by agreement between the committees described, without the appointment of a receiver, or it may be accomplished while the property is in the possession of the court. The receivership aims at the preservation of the business as a going concern without further deterioration in its earning power; reorganization aims primarily at a restoration of a balance between the debt liabilities of the corporation and its assets evaluated on a basis of their earning power as used by the corporation.

The various committees of security holders invariably will disagree as to the proper plan of reorganization. The receiver or the directors themselves may formulate a plan to which they will invite the consent of the committees of security holders. The various committees will usually prepare alternate plans of their own. A committee may announce their plan on behalf of themselves or through bankers or individuals whom

they may designate as reorganization managers. The plan drawn up by the committee is binding on the security holders who have deposited with the committee. They may, however, dissent and withdraw their securities if they do so within the time limit set forth in the agreement of deposit. Holders of securities who have not deposited are given a certain time to signify their assent and deposit their securities. If they fail to deposit their securities they are excluded from the benefits of the plan drawn up by the committee recognized by the court as representative of their class of securities. In the case of a sale of property to a new corporation organized to replace the old one, these dissenting holders of securities of the old corporation must take their chance of receiving value for their holdings, without obtaining securities of the new corporation.

The reorganization managers acting for the various committees may bend every effort to effect a reorganization without the expedient of a foreclosure sale, because of advantages that may attach to preserving the life of the old corporation. This corporation may hold valuable privileges, such as exemption from taxation, or authorization to engage in, say, both coal mining and railroad operations, under the same organization, which may have been forbidden to corporations since that charter was granted. The Philadelphia and Reading Railroad Company, for example, went through two reorganizations because its charter privileges were too valuable to be surrendered.

35. But the advantages of proceeding with a foreclosure sale almost invariably outweigh the advantages of avoiding it.

In the first place, by foreclosure sale the rights of nonassenting security holders are extinguished. The new company, whose security holders are the assenting security holders of the old company, is placed in control of the property that it desires to continue in operation. The use of the foreclosure sale makes possible the forcing through of a speedier reorganization when the court is satisfied that a majority of the parties interested are agreed on a plan and that the plan is fair enough to deserve the consent of all.

In the judicial sale of the old corporation's property through a decree of foreclosure, only the outward form of foreclosure sale is preserved. The court realizes that in a foreclosure of the property of a great corporation more capital is required to purchase than a single man or group of men can command, and that there will usually be no competition at the sale. In order to prevent the various parties who have agreed among themselves upon a workable plan of reorganization from conspiring together to purchase property for little and thus defeat the just claims of other creditors who have not pooled their interests, the court usually fixes a minimum "upset" price, which is the amount that the receivers must realize from the property in order that the court shall confirm the sale.

It is a foregone conclusion that the only bidder at the sale will be the representative of the Reorganization Committee and that his figure will be a few dollars above the price set by the court. So, in recent practice, many courts expedite matters by authorizing the receivers to give notice that they propose to sell at private sale the property of the corporation to the reorganization committee in furtherance of their prearranged plan of reorganization. If any one objects or can guarantee to outbid the reorganization committee at a public offering, the court will authorize a public sale. Ordinarily no one objects.

The name of the purchasing company, in the case of industrials, is usually altogether different from the name of the old company, in order that the new company may escape the bad reputation which failure may have brought to the old name. But the traveling and shipping public do not concern themselves over the failure of the railroad lines they use; so these and other public service corporations, after reorganization, retain the same name in so far as is possible, merely changing "railway" to "railroad" or "company" to "corporation" or vice versa.

After the foreclosure sale, creditors of the old company, who have not assented to the change of their securities for securities in the new company, may be paid off in money. The amount non-assenting bondholders receive is usually the proportional part which the face value of their bonds bears to

the sum received by the court from the sale of the actual property securing the bonds. Stockholders of the old company generally receive nothing; they were the owners of the property, not creditors; their interest is usually wiped out by the foreclosure decree and sale. They may, however, have agreed to pay for securities of the new corporation, if, in need of cash for reorganization expenses, the reorganization committee has offered to let them in on favorable terms in return for cash subscriptions.

36. The second of the advantages of using this method of foreclosure sale is that the organization of a new company and the dissolution of the old makes possible a greater concentration and simplification of the capitalization. In the case of a railroad with an intricate capital account, for example, branch line and terminal certificates, car-trust certificates, equipment bonds, and other obligations may be united under single issues, which are more easily managed, better secured, and of higher values than those which they displace. The property of the Northern Pacific Railway Company, for example, before its last reorganization, was owned by fifty-four corporations that had issued $380,000,000 of stocks and bonds. The circular of the reorganization committee described the old plan of capitalization as follows: "As it now stands, the system, in its form of incorporation and capitalization, is a development without method or adequate preparation for growth. Scarcely any single security is complete in itself. The main-line mortgage covers neither feeders nor terminals. The terminal mortgages may be bereft of their main-line support. The branch-line bonds are dependent upon the main line for interchange of business, and the main line owes a large part of its business to the branch lines."

The plan of reorganization of this company reduced the number of these obligations, and greatly simplified the capitalization, by subjecting the entire system to the lien of two bond issues, one following the other. Sinking-fund provisions, which have proved embarrassing to the corporation, may also be eliminated. An adequate bond reserve may be provided

under which, with proper restrictions, future issues of bonds for the capital needs of the company may be made. The company may also save in the exchange of securities by retiring high-interest bonds issued on branch lines where the security is not perfect, with lower-interest bonds secured by mortgage upon the entire property.

37. Sacrifices in Reorganization.—Virtually every reorganization involves present loss to the holders of the securities of the insolvent company. They will hope that the rehabilitated property and reorganized corporation will be of sufficiently increased earning ability and increased value in the future that they may eventually recoup their losses, but meantime there is the problem of reestablishing the insolvent business. Cash must be raised for working capital for the reorganized company and the heavy expenses of receivership and reorganization; and the interest charges of the company must be reduced.

To accomplish these purposes the reorganization committee may ask the several classes of security holders to make one or more of the following secrifices: payment of an assessment in cash; reduction in the par value of the securities held; reduction in the rate of interest due on bonds; exchange of junior lien bonds for preferred stock with the object of eliminating a direct liability.

The success of the committees representing the various groups of bondholders seeking for favorable position in the organized company, will depend in part on the priority of the lien in the case of various mortgage bonds; and in part, also, on the value to the new company of the properties that secure the bonds. For example, railroad bonds that are secured by mortgages upon important branch roads, terminal property or equipment, do not suffer in reorganization; the property which secures them is indispensable to the company. Senior mortgages may have had their interest fully earned by the insolvent companies; the holders of these will therefore expect the junior bondholders to bear any loss to be borne in the reduction of interest charges. If certain bonds are secured by

property that the reorganized company may decide it can as well or better dispense with, the holders of these bonds may be asked to foreclose on their property separately and be given no part in the reorganization. If their property is, for example, a branch transportation line useless except as a part of the bigger system, the holders of these bonds may lose very heavily.

38. General creditors are those who have no liens on the company's properties. A general creditor is a residual claimant, coming in ahead of the owners or stockholders but disadvantaged compared with holders of bonds, which have specific security. In a reorganization, the general creditors are but one step better off than stockholders. They cannot therefore expect very favorable treatment. Frequently they are asked to take some low-grade bonds, or even stock, of the new company in satisfaction of their claims against the old. They may have to submit to a cash assessment to get even this; otherwise they take a chance of getting what they may from the proceeds of the foreclosure sale.

General creditors have often been very summarily dealt with by reorganization committees. Since 1913, however, reorganization committees have been required to admit unsecured creditors in the reorganization, if they take in any stockholders. This was decided by the Supreme Court in the case of the Northern Pacific Railway Company vs. Boyd, known as the Boyd case. The Northern Pacific had been reorganized in 1896. In the reorganization there had been no provision made for the floating debt, which was considerable. A committee of unsecured creditors sought to defeat the foreclosure suit upon the ground that it was the result of a conspiracy between the bondholders and stockholders to exclude the floating debt and to turn over the valuable equity in the property to the stockholders.

But the Circuit Court held that the assets were insufficient to pay the mortgage debt and the net earnings insufficient to pay the fixed charges; that there was, consequently, no equity in the property out of which unsecured creditors could be paid.

It was held that the bondholders could make any arrangement that they chose to have the stockholders of the old company participate in a reorganized company. But 10 years later, the reorganized company having become prosperous, Boyd, the owner of an unsecured claim against the old company, brought suit to have his claim satisfied. The Court entered a decree making Boyd's claim a lien upon property of the old company in the hands of the new, but subject to the mortgages placed thereon at the time of the reorganization. The Supreme Court by vote of five to four affirmed judgment. The Court stated:

> The opinion of the majority of the Court proceeds upon the theory that while the bondholders might have lawfully bought in the property covered by the mortgage and kept it for themselves to the exclusion of both the unsecured debt and the stockholders, the moment they provided for participation in the new company on the part of the stockholders, even at the price of a heavy assessment, the obligation arose to make provision for the unsecured debt, which would recognize its priority to the interests of the stockholders.
>
> The prevailing opinion says: "This conclusion does not, as claimed, require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer, he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it."

39. The stockholders of an insolvent company invariably are obliged to pay an assessment to provide cash for the reorganized company if they wish to participate. They are owners, not creditors, of the insolvent company. They are in the weakest position of all classes of security holders of the insolvent company and are therefore the first to be called upon to pay cash.

Every reorganization requires much cash to furnish capital for development, to pay debts, to meet expenses of foreclosure, for underwriting of new securities, and so on. The cash requirements of the Atlanta, Birmingham & Atlantic Railroad

Company, 1917, typical of what may be expected in a reorganization, for example, was stated to be:

Obligations of Receiver for equipment acquired during receivership, tax loans, claims and judgments, interest, etc.	$1,105,491.52
To retire outstanding equipment obligations issued prior to receivership, with interest	930,237.50
Legal expenses of counsel for trustees in the foreclosure of the A. B. & A. R. R., Georgia Terminal and Alabama Terminal Railroad mortgages and the sales thereunder	66,000.00
Reorganization expenses, including trustee's fees and disbursements, partly estimated	185,224.93
Compensation and expenses of Receiver's Certificates Committee in connection with the purchase and management of the properties, the organization of the New Company, the negotiating of the underwriting etc.	84,546.05
Compensation which may be allowed by the court to the Receiver and his counsel	112,500.00
Commission to syndicate managers and underwriting syndicate	216,000.00
To treasury of New Company for working capital, improvements and repairs of equipment ($288,000)	900,000.00
Total	$3,600,000.00

Ordinarily the common stockholders are required to pay a cash assessment, and for this they receive common stock in the reorganized company, in proportion to their holdings of stock in the old company, usually less than dollar for dollar.

The preferred stockholders are not the residual participants in the ownership of the company, as are the common stockholders, and enjoy a better strategic bargaining position in the reorganization negotiations. They may have to pay an assessment, and receive common stock of the reorganized company in exchange for their preferred shares, but they pay less cash and receive stock more nearly equal in amount to the par value of their holdings. Sometimes part preferred and part common is given them in exchange for their old securities.

In some industrial companies one of the difficulties has been to get rid of accumulations of dividends on cumulative pre-

ferred stock. Many companies of prominence have been in arrears; many were delivered from their burdens by the prosperous years of the period of the war. Others have had to resort to reorganization. The preferred stockholders cannot be expected to give up, readily, their right to dividends in arrears. But they may, first, accept securities for back dividends, that is, the back dividends may be capitalized. Or, second, they may accept securities with a higher rate of preferred dividends, but without the cumulative feature. That is, they may exchange a degree of certainty for an opportunity to receive a greater income. Or, thirdly, they may get a greater degree of certainty, surrendering the possibility of getting certain income, by accepting bonds bearing a lower rate of income than the preferred stock in exchange for that stock.

40. The offer to stockholders, if foreclosure is not involved in the reorganization plan, is usually more liberal than when the threat of foreclosure can be used to induce subscriptions. If the method of foreclosure is not to be employed, then the stockholders must be persuaded into the subscription by an attractive offer. An offer may be made to the stockholders to subscribe to the securities of the new company, in one of two forms.

First, it may be impressed upon them that the company they own has failed; that it is unable to pay its debts; and its creditors have liens upon all its properties. That unless the stockholders agree to furnish the cash needed for the reorganization, the property must be sold by the court, and the stockholders will be without hope of ever recovering their present losses. In the foreclosure sale, no matter how a claim may actually be, each evidence of debt will have a claim for 100 cents on the dollar before anything can go to the stockholders. The creditors will control the situation. The only hope the stockholders have of recovering their losses is by receiving securities of the reorganized corporation, which securities may mount in value as the corporation prospers. But the stockholders can receive these securities only on terms agreed to by the creditors of the old company. The creditors, how-

ever, hope to get all the cash needed for reorganization from the stockholders, and, in a reorganization plan, come to terms with the stockholders. So, pointing out to the stockholders the weakness of their position, the creditors make their proposition. As in the case of the Westinghouse Electric and Manufacturing Company, the failure may be due, not to total insolvency, but merely to the fact that, owing to the condition of the bond market at the time, it is unable to fund current debt on which it is well able to pay interest. In that case, the stockholders will be threatened with a foreclosure sale and then asked to subscribe to new securities. The Westinghouse reorganization referred to, affords an example of such a call upon stockholders for subscriptions. In the reorganization certain bonds of the company were not to be disturbed; the floating debt was to be in part funded into bonds and notes, and in part converted into stock. The stockholders were asked to subscribe for $6,000,000 of this new stock at par. The stockholders' committee presented the following proposition to the stockholders:

The chief difficulty with the company and the principal cause of the receivership are found in the fact that as the result of the rapid expansion of this business, too large a proportion of its investment is represented by debt. If a substantial reduction can be made in the debt by sale of additional stock, it is believed that the receivership can be promptly terminated with every prospect of the company entering upon a career of renewed prosperity. On this point the committee, of which Mr. Jarvie is chairman, in their circular of April 2, 1908, say:

"The committee believe that if the conduct of business can promptly be restored the stockholders under the direction of a strong board of directors, the company will continue to make substantial earnings. On the other hand, there can be no doubt that a continuation of the receivership for a considerable time, and a forced liquidation of the assets, would be disastrous to the creditors as well as the stockholders."

The Merchandise Creditors' Committee has shown their confidence in the company and its future by undertaking to secure the exchange of at least $4,000,000 of the company's floating debt for assenting stock at par. They, however, impose the condition that the remaining $6,000,000 of the $10,000,000 of the subscription required to terminate the receivership and place the company in a safe position

shall be furnished by the stockholders. It is for the purpose of securing from stockholders subscription to this $6,000,000 of stock that the undersigned committee has been formed.

The holders of the preferred and common stock of the company are, therefore, asked to subscribe for "assenting stock" of the company at par, at the rate of at least one share of new stock for every four shares (or fraction thereof) of existing stock. Such subscriptions are to be payable in the following instalments:

25 per cent. on May 25, 1908.
20 per cent. on August 1, 1908.
20 per cent. on November 1, 1908.
20 per cent. on January 1, 1909.
15 per cent. on April 1, 1909.

The deferred payments are to bear interest at the rate of 6 per cent. per annum, with the privilege to subscribers to pay their subscriptions in full at any time.

The Merchandise Creditors' plan cannot be carried into effect unless the stockholders protect themselves by subscribing pro rata to the shares of this new stock. If these subscriptions are not forthcoming the inevitable result will be that the Readjustment Committee, which was organized for the protection of creditors, will be forced to reduce the debt of the company to judgment, bring about a forced sale of the property, and its acquisition by a new corporation organized in the interest of the creditors. Such a course would result in an enormous loss, which would fall chiefly upon the stockholders of the company. That loss can be avoided only by the cooperation of stockholders in promptly subscribing for a sufficient amount of new stock to insure an early termination of the Receivership.

The Committee wish to lay especial emphasis upon the fact that the success of this plan for saving the company for the stockholders requires the unanimous compliance of stockholders, however small their holdings, to this request for subscriptions. The ownership of the stock of the company is divided among about 4,000 stockholders, the average holding (excluding the holdings of the Security Investment Company and its President) being only about eighty-three shares (par value $50.00). Most of the stock owned by the Security Investment Company has been pledged as collateral in comparatively small amounts with a large number of banks that are being asked to subscribe to the new stock in proportion to their respective holdings.

41. When the failure of a company is due to what has been defined as total insolvency, the equity of the stockholders, of course, has been destroyed. To the stockholder, further

investment with the insolvent company might look like a bad investment or a speculative proposition. When a stockholder is asked to subscribe, he is being asked to give up cash for new securities. Naturally, a stockholder is desirous of holding on to what he has, but does not care to take any more equally worthless stock. In such case, a certain form of request is used. Instead of asking the stockholders to subscribe, it it proposed that the stock be assessed at so much per share. But, inasmuch as the stockholders are only given new securities in exchange for the cash face surrender in assessments, it is evident that the form of assessment is merely a disguise for subscription. Through this method of calling a subscription to stock in a new company an assessment on stock in an old company, many stockholders are made to undergo a different psychological reaction. So imperfectly is the average stockholder aware of his rights and obligations as a stockholder, that he is likely to feel, when an assessment is urged upon him, that he is under obligation to pay; as a matter of fact his full-paid stock is not assessable. He cannot be obliged to pay more money to a corporation, or to subscribe to any more securities; the payment of a reorganization assessment is not compulsory.

The stockholder owes nothing to the reorganization managers or to creditors of the company. If the managers or creditors wish to secure his participation to the new company, furnishing through him the cash needed for the reorganization, the stockholder should insist on being offered a more attractive investment or speculative proposal than he can find elsewhere. The stock of the new, or reorganized, company should be offered him in return for his cash subscription, or assessment, at a lower price than he can purchase it for in the open market. Otherwise, he will be much wiser to ignore the appeals of the reorganization managers and let the creditors themselves furnish the cash for the reorganization; and then, when the reorganization is completed, purchase stock in the open market. A number of examples might be given where stockholders have ignorantly or foolishly submitted to a reorganization assessment, which amounted to buying, with cash, stock in a new

company, and have paid more for it than they would have had to pay in the open market directly after the reorganization.

42. It is usual to make use of underwriting syndicates in reorganizations. Where a reorganization plan provides for the obtaining of the necessary cash for reorganization from the stockholders by assessment, and the equity of the stockholders may be so far destroyed that there remains serious doubt as to whether they will pay the assessment, there will be difficulty in securing bankers to underwrite the assessment. This problem is usually met by requiring the holders of the securities next in line to act as intermediate underwriters of the assessment, forming a syndicate to underwrite the participation of this last class of securities. In a recent reorganization, for example, that of the Wabash Railroad Company in 1915—the market value of the preferred and common stock had dwindled to almost nothing. The reorganization plan called for cash to the amount of $27,000,000. This was to be obtained by an assessment of $30 per share on the preferred and common alike, and for this assessment the payers were to receive new Five Per Cent. Profit Sharing Preferred Stock, and Common Stock. Inasmuch as the equity of the stockholders in the railroad property had all but disappeared it was a question if they would give up $30 per share in exchange for still more stock of practically no market value. It was evident that no bankers would underwrite such a plan. Therefore, the plan provided that the bondholders whose mortgage was being foreclosed should be required to underwrite the participation of the stock. That is, that they should agree that such amount of the required cash as was not forthcoming from the assessment on the stock, should be furnished by these bondholders. Another example is that of a recent reorganization of an industrial company which had outstanding about $10,000,000 in bonds, $11,000,000 of preferred stock, and $17,000,000 of common stock. The property if sold at a forced sale would not yield enough to pay the bonds. The bonds were then selling on the market at about 44 per cent. of par; the preferred

stock was selling at 6 per cent. and the common at 3 per cent. of par. The reorganization plan called for cash to the amount of $3,600,000. This was to be obtained by an assessment of $12.50 on each share of preferred and common stock equally. In exchange for the cash assessment the stockholders were to receive new first preferred stock, to be issued at par, dollar for dollar.

In this case the bondholders insisted that the committee of preferred stockholders should guarantee the assessment of the common stock and agree to furnish whatever cash the common stockholders failed to pay. While there was doubt about the participation of the common stock, there was every assurance that the preferred stockholders would stand the cost of staying in the reorganization; a syndicate of bankers was then formed to underwrite the participation of the preferred shares, including the amount which the preferred guaranteed as forthcoming from the assessment from the common shares.

It may be expedient, and possible, for the secured creditors to admit the unsecured creditors into the reorganization, even though they are not obliged to, when the stockholders have failed to furnish the cash and participate. The amount of the floating debt—that owed to the unsecured creditors, also called floating-debt creditors—may be very heavy, and rather than lose all or most, these unsecured creditors may be persuaded to participate in the reorganization by furnishing the immediate cash in exchange for securities at a reasonable price. In the Westinghouse reorganization, already referred to, the insolvent company owed $5,000,000 for merchandise and $8,000,000 to banks; the banks and merchandise creditors had no security for these loans. In such cases, if the stockholders refused to participate, the floating-debt creditors may receive stock of the new company in exchange for cash, and in consideration of the debts owed to them by the old company; they may furnish at least part of the needed cash. The securities of the new company, which they acquire in exchange, may be of any type suitable to the adjustments required in capitalization, either common or preferred stock, notes, or bonds.

It is quite possible that the stockholders will fail to subscribe to any or all of the securities offered them. The burden of furnishing cash in the reorganization will then fall upon the creditors of the insolvent corporation. In such case they may eliminate stockholders in a foreclosure sale, purchase the property, furnish the cash for its rehabilitation and working capital, and operate the new company. As a result of the Boyd decision, elsewhere referred to, at least one advantage is had for secured creditors; if the stockholders are not admitted to the reorganization, the unsecured creditors do not have to be admitted, and smaller capitalization will be possible for the reorganized company. The secured creditors of the old company arrange the new capitalization to suit themselves; they may issue to themselves all the securities, including the stock, of the new company, or they may offer some for public subscription, in order to get working capital, or capital for rehabilitation or expansion.

43. Underwriting the Reorganization. — It must be emphasized that an underwriting syndicate should be employed in reorganizations. A reorganization plan usually will not succeed unless all the cash calculated as necessary is forthcoming. Since old security holders cannot be forced to pay assessments, absolute assurance of acquiring the cash can be obtained only by employing a syndicate. A syndicate may be formed to agree to pay assessments for a given commission. For example, if a stockholder does not pay, the syndicate may be given the same rights that a stockholder would have had if he had paid the assessments, and this, in spite of the fact that the syndicate had no rights in the old company. If, on the other hand, holders of important bonds do not come into the reorganization, the syndicate may be given only a portion of the interests that would be given to those bondholders had they assented. A syndicate also underwrites the sale of the new securities that are to be offered to outsiders. In all cases, both as to the assessment and as to the new securities, the commission of a syndicate will depend on the risk run. In the case of the assessments the risk will depend largely on the

severity of the reorganization plan. If the paring down of rights is not drastic, and the assessments are not heavy, the security holders who do not come in will be few, and the syndicate will have to put up but little cash; where the plan is drastic, the risk will be great and the commission necessarily higher.

44. The Voting Trust.—The voting trust is used most commonly in connection with reorganization. At such a time the creditor interest usually represents a far greater actual investment in the corporate property than does that of the stockholders. The stock of a reorganized corporation will sell at a low figure; it is distinctly speculative, pending demonstration of increased earning power of the reorganized business. Much of it, therefore, will fall into the hands of speculators, and stock brokers who have little or no interest in the permanent welfare of the corporation. Yet, because of the voting power attaching to the stock, these holders can exercise an absolute control over the property. A clever speculator can acquire control with little cash outlay, jeopardize the large interest of the bondholders who have already sacrificed much to get the business back on its feet, and may impede or prevent the effective recovery of the business.

To prevent this, in the reorganization plan it will usually be provided that the common stock, and often the preferred as well, shall be placed in a voting trust controlled by three or five men of reputation for honor and ability. As a result, all interests are protected by men of acknowledged honorableness and trust. The reputations of these trustees are at stake; they know that the success or failure of the reorganized company will be laid to their credit or discredit. These trustees are sure of undisturbed control and can work out their policies to their conclusion. Were it not for this arrangement, the control of the company would be bought and sold from day to day, and its policy and management would be subject to sudden and surprising change, this change rendering the fulfilment of any considered policy impossible. Usually, it is the practice to provide for the termination of a trust either as soon as the business is sufficiently rehabilitated to permit the declaration

of dividends, or after a specified number of years, usually five.

Instead of the expedient of the voting trust, however, that of management shares may be employed to attain the same objects. A nominal amount of management shares may be issued to a group of people representing the bondholders. These shares, few in number, proportionately, will be given voting powers assuring them of a control over the directorate of the corporation. The management shares may be made redeemable on short notice, and convertible. When a business is successfully reestablished they may be called in for redemption.

FINANCE AND INVESTMENT

(PART 5)

Serial 2253E Edition 1

EXAMINATION QUESTIONS

Notice to Students.—*Study the Instruction Paper thoroughly before you attempt to answer these questions.* **Read each question carefully and be sure you understand** it; *then write the best answer you can. When your answers are completed, examine them closely and correct all the errors you can find; then mail your work to us.*

(1) Discuss briefly the methods of effecting a merger of corporations.

(2) What is stock control, and how is it worked out as a form of consolidation of corporations?

(3) Explain briefly the working of a corporate lease.

(4) What is the purpose and plan of a holding company?

(5) (*a*) What is insolvency? (*b*) What degree of insolvency is described as total insolvency?

(6) What is the object of a security holder committee?

(7) Briefly describe a receivership.

(8) What is a reorganization, and, briefly, how is it worked out?

(9) Explain how, at times, reorganizations are underwritten.

(10) What is a voting trust?

Mail your work on this lesson as soon as you have finished it and looked it over carefully. DO NOT HOLD IT until another lesson is ready.

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